



**UNIDROIT COMMITTEE OF GOVERNMENTAL EXPERTS FOR
THE PREPARATION OF A DRAFT CONVENTION ON
SUBSTANTIVE RULES REGARDING INTERMEDIATED
SECURITIES
Third session
Rome, 6/15 November 2006**

UNIDROIT 2006
Study LXXVIII – Doc. 49
Original: English
October 2006

***COMMENTS BY GOVERNMENTS
AND INTERNATIONAL ORGANISATIONS***

(Comments by the Government of Switzerland)

Note on the need for a transition rule

The present note outlines the need for a transition rule of limited scope. It may be that other transition issues need to be addressed. If so, they should be identified as early as possible.

The most significant transitional problem that will result from the adoption of the Convention relates to the priority of security interests previously created under the domestic non-Convention law and which had not been made effective against third parties in accordance with one of the internationally recognised methods contemplated in Article 5 (1) to (3) of the Draft UNIDROIT Convention (Doc. 42, March 2006, “the Convention”). The problem is best illustrated by some fact patterns.

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 5 (1) and (2). 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 domestic non-Convention law regards a control agreement as sufficient to deliver securities, Article 5 (3) and (4), the security interest obtained by CT enjoys a first-in-time priority in accordance with Article 6 (2). Any subsequent security interest created by AH in accordance with Article 5 (3) and (4) would rank below, whether they are 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 7.

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

Article 5 (8) does not prohibit the domestic non-Convention law to enable filing of security interests but Article 6 (5) ranks the priority of such interests below any (prior or subsequent) security interest created in accordance with one of the methods listed in Article 5 (2) or (3). 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 6 (2)(b). IM's security interest, which ranked before under domestic non-Convention law, now ranks second after CT-1's interest. A transition rule should allow IM to preserve its priority.

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.

One possibility would be to provide for a grace period after the entry into force of the Convention for the relevant Contracting State.

During the grace period:

- a) All existing security interests would remain valid and retain their priority as determined by the domestic non-Convention law in effect immediately before the entry into force of the Convention.
- b) Collateral takers should be able to take a preservation action to make their security interests effective against third parties in accordance with one of the internationally recognised methods listed in Article 5 (2) and, subject to domestic non-Convention law, in Article 5 (3).
- c) Domestic non-Convention law should appropriately regulate the required preservation actions and should, when necessary, require the collateral providers to assist.

After the expiration of the grace period:

- d) If a preservation action has been taken during the grace period, the relevant security interest should continue to enjoy the priority it enjoyed under the domestic non-Convention law before the entry into force of the Convention.
- e) If a preservation action has not been taken, the relevant security interest would not be extinguished but it would become junior to any security interest that has been or will be made effective against third parties in accordance with Article 5 (2) and (3) of the Convention, including pre-existing security interests for which a preservation action has been taken.

The grace period should be determined by the Convention. It must be long enough for collateral takers to review their books and take promptly any action that is necessary. It needs to be short enough so that creditors and collateral takers (past and future) have the situation clarified and enjoy legal certainty as early as possible.

One should not over-estimate the number of actions required to preserve the priority of security interests created before the adoption of the Convention. Generally, most collateral is held by intermediaries in securities accounts they maintain. To the extent that a Contracting State has declared that such securities are treated as delivered to the relevant intermediary by the domestic non-Convention law, no further action is required.

It should be noted that the suggested approach is compatible with the Hague Securities Convention of 2006. According to its Article 2(1)(d), the law designated by the Convention determines “whether a person’s interest in securities held with an intermediary extinguishes or has priority over another person’s interest”. For parties to the UNIDROIT Convention, the law applicable under the Hague Convention will include the UNIDROIT Convention.

Assuming that, in a particular case, the conflict of law issue is governed by the Hague Convention and that the applicable law is the law of a State which is a party to the UNIDROIT Convention, then the priority among pre-UNIDROIT-Convention interests and between pre-UNIDROIT-Convention and post-UNIDROIT-Convention interests will be governed by the UNIDROIT draft Article 6 and by the transition rule discussed in this note. (Please remark that Article 15 of the Hague Convention does not apply here because it addresses a different question, *i.e.* the relationship between pre-Hague-Convention and post-Hague-Convention interests.)

Conversely, if the Hague Convention designates the law of a State which is not a party to the UNIDROIT Convention, no transition issue arises in connection with the UNIDROIT Convention; priorities are governed by the domestic law of that State.

It is also worth noting that a grace period is compatible with the approach recommended in chapter XIV of the current UNICTRAL Draft legislative guide on secured transactions.