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FINNISH LEGAL REQUIREMENTS FOR T2S

1 Introduction

Following a number of discussions between the ECB experts and the Finnish User Group regarding TARGET2-Securities, we would like to provide an input to the legal evaluation being prepared by the ECB. In this paper, we examine the Finnish legal system structure and explain the objectives behind and justifications for the structure. We also discuss the system specifics in relation to the general requirements for the T2S.

The specific legislation governing the Finnish system seeks to safeguard legal certainty, the transparency of ownership, adequate supervision and effective finality of settlement transactions. The system is based on direct holding of book-entry securities. All securities accounts, even those of final investors, are maintained by the CSD. Account centralisation enables true competition by allowing the investors to choose their broker, clearing party and custodian independently from each other.

Despite of the centralisation, the system could not work without participation of account operators interposing themselves between the CSD and the investor. Licensed account operators have the right to make entries to the securities accounts in accordance with instructions of account holders. The account holders have contractual relationship only with licensed account operators (usually banks and brokers) who, on the basis of specific legislation, make the actual registrations in securities accounts with proprietary effects in accordance with the instructions of the account holder. While each account operator is generally only entitled to make entries to the accounts it administers, the system allows also other account operators to register effective entries in the investor's account upon his authorisation.

In the Finnish system, final investors' securities accounts shall contain all the relevant information concerning securities holdings, including, inter alia, rights and restrictions. T2S in turn is functionally based on an indirect holding pattern in which intermediaries hold securities in fungible pools in omnibus-accounts.

The Finnish legislation on book entries consist mainly of two Acts, namely the Act on Book-Entry System (826/1991) that defines the system and the roles of the parties; and the Act on Book-Entry Accounts (827/1991) that defines in more detail the types of accounts and the entries that can be registered. Moreover, in chapter 4a of the Securities Market Act there are rules about the clearing operations and the licence of the CSD.

The following examines the main legal requirements that have to be fulfilled so that the T2S will be compatible with the Finnish legislation in

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this respect¹. This would facilitate the CSD's (APK) decision making whether to join the T2S, and the approval of the Ministry of Finance for the APK to outsource some of its activities to T2S.

2 Data-content of the book-entry register and accounts

According to the Act on Book-Entry Accounts, the book-entry register maintained by the CSD consists of:

- book-entry accounts (securities accounts), section 2,
- list of holders of rights with respect to securities credited to securities accounts, section 3, and
- list of securities credited to securities accounts, section 4

Section 2 defines in detail the information that has to be registered on a book-entry account. Thus, a securities account should contain information on the following:

- 1) the account holder as well as other holders of rights pertaining to the book entries registered in the account;
- 2) the type and number of book entries registered in the account; as well as
- 3) rights and restrictions pertaining to the account and to the book entries registered in the account.

Furthermore, the book-entry account shall, inter alia, contain an indication of the account operator managing the account in question. The information requirements established by the section 2 are further detailed in sections 5 – 9 and 16 (see Annex I).

In addition to the information described above, the Finnish book-entry register includes also lists of holders of rights and types of book entries, defined in sections 3 and 4 of the above mentioned Act respectively. According to section 3, the list of holders' rights should include the following information:

- 1) The entry made on the holder of a right shall include his name as well as the necessary contact, payment address and taxation information.
- 2) With regard to the holder of a right, also the Finnish personal identity number or, in the absence thereof, an identification code in compliance with the regulations of the CSD shall be entered.

With respect to the list of types of book-entries, the section 4 stipulates that the list of book entries shall contain the information on the book-entry to be entered in the issue account under section 27 of the Act on the Book-Entry System (see Chapter 3 below) with the exception of the number of the book entries. Book entries shall be recorded in the list by type. Warrant and subscription rights shall be recorded as independent book entries when they

¹ This note addresses the legal issues related to the specific legislation covering book-entries and book-entry systems. Potential requirements arising from other, general legislation, such as the Finnish Companies Act, would need to be analysed in the next phase.

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are separated from the share, participation or main commitment as individual transferable rights.

Thus, from legal perspective, the book-entry register has to contain the three elements above, i.e. securities account information, list of holders of rights and list of book entries. These elements cannot legally be separated. Likewise, a securities account has to contain all legally relevant information which cannot be separated to be held in different registers since otherwise requirements of legislation would not be fulfilled.

Yet, it is another question how and where the data with respect to above is kept/stored in a technical sense. Obviously, technical arrangements must not lead to legal changes or uncertainties and must provide all pieces of information real time. If different pieces of data were stored separately with no absolutely reliable real time connection, legal risks can arise and settlement could be delayed and/or prevented.

With the view to above, it is to be stressed that in order to ensure legal certainty and gain cost-efficiency benefits, locating data in different places, even in technical sense, should be avoided. Therefore all the securities account information should be able to be located in T2S also in a technical sense. This requires, as an absolute minimum, that they should contain all the data required by section 2 of Book-Entry Accounts.

In addition, although the Finnish book-entry system is based on the direct holding of book entries there are some cases in which the holder of an account is not the beneficial owner of the assets. Information registered in an account should reflect the situation that the holder of an account is a custodian who administers an account on behalf of a foreign individual, corporation or foundation. Furthermore, the Act on the Book-Entry System (section 28) enables a nominee registration if a book-entry is registered in a custodial nominee account or in the commission account. In that case a nominee may be entered in the list of owners kept by the CSD instead of the investor.

Consequently, it is clear that Finnish securities accounts contain a great deal of information. There should be an appropriate solution for this in T2S. There has been discussion about so called CSD specific free-format fields, but further details are necessary to establish the feasibility of this solution. In any case, information in the free-format fields must be stored and be accessible like any other information in T2S.

3 Issue account

According to the Act on Book-Entry System (section 27) an issue account shall be opened upon the incorporation of a book-entry in the book-entry register. The issue account contains the information that, under the law, should be entered on the security issued for the book-entry in question and the

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number to be issued. This means that the issue account gives information on the due dates, the possible security for the loan, the interest payable on the loan or other possible compensation, the repayment and other essential terms of the loan and how the terms of the loan are kept available to the public. Since there are no certificates, the system shall provide basic information on the relevant terms and conditions of the securities. The information registered in an issue account is also very important for the CSD as its duty according to the Act on Book-Entry System (section 13.1 (5)) is to monitor that the number of book entries registered in the book-entry accounts corresponds to the number in circulation. Furthermore, it can be noted that the pieces of information registered in the issue account are the basis for the list of securities. The list of securities is the basis for the protection against claims in the relationship between the issuer and the investor.

There should be a possibility to keep issue accounts in T2S, for which purpose the role and location of an issue account in T2S environment should be clarified. The free-format-fields may be a solution also for this problem, but with the same caveats mentioned above.

4 Commission account

Section 16 of the Act on Book-Entry Accounts defines a specific book-entry account for clearing and settlement purposes. The CSD, the central bank, an account operator, a clearing party and a foreign institution approved by the CSD may open commission accounts in which securities owned by the account holder or its customers may be registered on temporary basis to facilitate clearing and settlement. Detailed provisions on the opening and use of commission accounts are provided in the Rules of the CSD. The securities credited in the account are nominee registered. In this case, also securities owned by Finnish natural and legal persons can be held under a nominee name temporarily. Securities owned by the account holder and its customer may not be registered in the same commission account. Chapter 4a, section 11 of the Securities Markets Act provides a statutory lien on securities credited in a commission account under certain circumstances.

5 Account operators, agents and right to make registrations

The Act on the Book-Entry System (section 2b) defines an account operator as an organization that has been granted the right to make registrations in the book-entry register. An account operator corresponds with a T2S party. However, the roles and rights of account operators (e.g. what they can do directly and what must be done via the CSD) are still unclear in T2S.

An account operator may, under a contractual arrangement, give to another organization the right to make registrations in the book-entry register on

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behalf of the account operator (agent of an account operator). This kind of an agency structure seems to be missing in T2S, and should be implemented.

According to the Act on Book-Entry Accounts (section 16c) the registration decision is made by the account operator managing the account. However, upon the order of the account holder, also another party than the account operator managing the account may make registrations in the account. Information on the said organization as well as any restrictions relating to its registration authority shall be entered in the book-entry account. The facility is needed if the account holder has contractual relationships with several actors on the securities market. This requirement should be facilitated by T2S.

6 Night-time settlement

Night-time settlement is provided in the schedule of T2S settlement day. This means that the settlement date changes already in the evening of the previous calendar day. There are some additional legal risks in the night-time settlement that could be avoided if an early morning settlement cycle were used.

Under the Act on Book-Entry Accounts (section 26) the general rule is that an acquisition and right registered in the book-entry account have priority over an acquisition and right not registered in the account. If mutually conflicting interests pertain to the same book-entry, the right first registered in the book-entry account has the priority over a right registered later. It is very important to know the exact point of time when each and every registration is made and therefore there have to be timestamps available in the system. It should be clarified what kind of a timestamp will be given in late evening in T2S, the current draft URD is silent on this. We wish to note that the first-in-time priority rule is recognized also in the Unidroit negotiations and in the EU Legal Certainty work.

However, according to the information received bilaterally from the ECB, the system-clock runs according to CET, meaning that book-entries made during the evening will get a later time-stamp than e.g. bookings made early in the morning of the same value date. If this information is confirmed, the T2S should provide facilities to establish the right order of book-entries made.

The Settlement Finality Directive (SFD, 98/26/EC) defines the terms "entry into a system" and "enforceability" which are important when deciding a binding effect of a transfer order in an event of insolvency proceedings. The SFD is implemented in different ways in several countries which may cause that the moments that have legal effects in settlement procedure may vary in different countries.

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In Finland, the SFD is implemented in the Netting Act (1084/1999). The protection against insolvency provided by the Netting Act is based on the Art. 3 of the SFD. The "day of opening of the bankruptcy" is considered to mean a calendar day. Thereby, the transactions settled before midnight (Finnish time) may be treated differently from those settled after midnight with respect to protection against insolvency.

7 Transfer of an account from one account operator to another

According to the Act on Book-Entry Accounts (section 16b) it is possible on request of the account holder to transfer a whole book-entry account with all effective registrations to be managed by another account operator without the possibility of the assigning account operator to oppose the transfer. This provision was included in the law to promote competition, and the account holders exploit the possibility relatively widely. The pledge holder can prohibit the transfer of an account and such prohibition may be registered on the pledged book-entry account. T2S should also support this functionality.

8 Temporary registration

A temporary registration can be made according to the Act on Book-entry Accounts, section 18, if a registration application is incomplete and if the application is not immediately dismissed or rejected. In that case the applicant is notified of the nature of the incompleteness of the application, the last date on which he may supplement the application and the consequences of failure to comply with the request to supplement the application. If the applicant presents the required additional information within the given period, the final registration is deemed made at the time of temporary registration which means the value on a previous value date. Otherwise a temporary registration shall be without effect. Such a temporary registration should be possible in T2S (e.g. as a conditional entry).

9 Outsourcing and preparedness

Duties of the CSD are listed in the Act on Book-Entry System in section 13; the CSD shall i.e. maintain the central data system necessary for operation of the book-entry system. According to paragraph 3 the CSD may, by permission of the Council of State, transfer attendance to the duties referred to in the Act on Book-Entry System to another organization. The Council of State has to investigate whether sufficient requirements are fulfilled so that the permission can be given.

Furthermore, the Council of State may also take note on section 13a of the Act on Book-Entry System that sets the requirements for the CSD to ensure maintenance of the information in the book-entry register with as little

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disturbance as possible also in exceptional circumstances by participating in the preparedness planning of financial markets and by preparing in advance the actions to be taken in exceptional circumstances as well as by other means. This section 13a may change when the Bill on Emergency Powers Act forwarded to the Parliament in February will be passed. The new drafting requires that the CSD should have adequate information systems in Finland.

Moreover, also the requirements of the Finnish Financial Supervisory Authority with respect to outsourcing and preparedness must be fulfilled. These requirements are presented in the supervisory Standard 1.6 (Standard on Outsourcing Arrangements) and Standard 4.4b (Standard on Management of Operational Risk).

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Annex 1: Act on Book-Entry Accounts 17.5.1991/827, sections 5 – 9 and 16
Unofficial translation, updated in September 2006

Proxy and right to operate an account

Section 5

The following may be registered in a book-entry account:

- 1) an unrestricted right to transfer book entries from the account or otherwise to administer the book entries registered in the account (portfolio management proxy);
- 2) the right to transfer specific book entries from the account;
- 3) the right to obtain information on the contents of the account; and
- 4) the right to receive the yield, warrant rights or subscription rights or amortization or other payment based on the book entries registered in the account.

Without prejudice to an agreement on the period of validity of a right referred to in paragraph 1, subparagraph 1-3, its recording shall be cancelled upon the application of the account holder if the account holder proves that the proxy holder has been informed of his application for cancellation.

Custodial nominee account (8.12.1995/1387)

Section 5 a (8.12.1995/1387)

Book-entry securities owned by a foreign individual, corporation or foundation may be entered in a special book-entry account (custodial nominee account) administered by a custodial account holder on behalf of a beneficial owner on the basis of an authorization. Such accounts must contain information on the custodial account holder instead of the beneficial owner and include a mention that the account is a custodial nominee account.

A custodial nominee account may be used for the keeping of book-entry securities owned by one or more beneficial owner(s). The provisions of this Act governing the entitlement of the account holder to dispose of book-entry securities registered in a book-entry account shall also apply to the custodial account holder of a custodial nominee account.

The account holder of a custodial nominee account may be a central securities depository, a central bank or an account management organisation. The central securities depository may approve as an account holder also a credit institution or an investment firm entitled to offer safekeeping and management services pertaining to book entries, a foreign institution referred to in section 16 of the Act on the Book-Entry System (826/1991) or another foreign organisation which is subject to sufficient public supervision and whose economic operating conditions and administration fulfil the requirements set on the reliable attendance to the duty. Without prejudice to the provisions of subsection 1, also book-entries owned by a Finnish citizen or a Finnish corporation or foundation and referred to in section 4, subsection 2 of the Act on the Book-Entry System may be entered in the custodial nominee account held by a foreign institution referred to in section 16 of the Act on the Book-Entry System. (28 December 2001/1520)

If the holder of a custodial nominee account or a client of the holder keeps a register or an account of the rights pertaining to book-entries in another state, the law of that state shall be applicable to the rights of a right holder, unless the registrations pertaining to the account state otherwise. (26.11.1999/1085)

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Pledge and levy of execution

Section 6

The entries registered in a book-entry account may include the pledge of a book-entry, with the exception of a business facilities mortgage, as well as a levy of execution and a protective measure pertaining to the book entries. Such registration shall pertain to the book-entry account in toto. Where such registration is to apply only to certain book entries registered in the book-entry account, a separate account shall be opened for them.

The registration of a right, restriction or measure referred to in paragraph 1 above shall indicate the commitment or other basis that the book entries are liable for, as well as whether the yield or capital on the book-entry is to be paid to the account holder or pledge holder or the competent execution authority. Unless otherwise agreed upon or stipulated, a dividend or interest or other such yield shall be paid to the account holder, and amortization, subscription and warrant rights, the right to a new share and other payments to be deemed as capital of the book entries pledged shall be paid to the pledge holder or the competent execution authority. (5.11.1993/919)

A secondary pledge may not be registered on a right of pledge registered in a book-entry account. Nor may a right of pledge for another receivable be registered on a pledged book-entry. (5.11.1993/919)

Section 7 (20 January 2004/13)

A contract term on the right of disposition of the pledge holder referred to in section 5 of the Financial Insurance Act (11/2004) may be registered in a pledged book-entry account. The registration may not be removed without the consent of the pledge holder.

If the pledge holder under the right of disposition referred to in subsection 1 conveys or otherwise transfers the proprietary right to the pledged book-entry, it shall be registered in the book-entry account of the assignee. If the pledge holder establishes a new right of pledge, the book-entry shall be transferred to his book-entry account where the new pledge shall be registered.

Joint ownership

Section 8

Book entries owned jointly by two or more persons shall be registered in an account with all the joint owners registered as account holders.

Restriction on disposal

Section 9

A book-entry account may contain a registration indicating that the book-entry has been conveyed, but that, due to a reservation of title or other such factor, the conveyance is not yet final.

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Commission account

Section 16 (15.9.2000/796)

In order to arrange the operations of a clearing organization referred to in chapter 4 a of the Securities Markets Act (495/1989), the book entries of the Central Securities Depository, a central bank, an account operator, a clearing organization and a clearing party as well as of their customers may be registered in a special book-entry account (commission account) in the manner separately provided for in the Rules of the Central Securities Depository. The Central Securities Depository may approve as a commission account holder also a foreign institution referred to in section 16 of the Act on the Book-Entry System or another foreign organization which is subject to sufficient public supervision and whose economic operating conditions and administration fulfil the requirements set on the reliable attendance to the duty.

Book-entries owned by the account holder and its customer may not be registered in the same commission account.

Rights of pledge pertaining to book-entries registered in the commission accounts referred to in this section shall be governed by the provisions of chapter 4 a, section 11 of the Securities Markets Act.