

International Swaps and Derivatives Association, Inc.
COLLATERAL LAW REFORM GROUP

FINLAND

COUNTRY REPORT

Supplement to
*Collateral Arrangements in the European Financial Markets:
The Need for National Law Reform*

March 2000

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Summary report on the legal framework for collateral arrangements for financial activity

Summary of the legal analysis under the laws of Finland applicable to collateral arrangements intended to secure financial trading activity in relation to privately negotiated derivative transactions, securities trading, securities repurchase transactions, stock lending and similar financial transactions in the wholesale financial markets. It is assumed that at least one of the parties involved is a financial institution (credit institution or investment firm) and that the collateral involved is cash, in euros or some other freely available currency, and/or fungible securities listed on a stock exchange or recognised market and held in immobilised or dematerialised form in a clearing system (“Fungible Securities”). References to “collateral” below indicate cash and Fungible Securities, unless otherwise specified.

This summary was prepared for the purpose of identifying possible areas of uncertainty or commercial impracticality arising under the laws of Finland in relation to collateral arrangements. It is not intended to be a definitive summary of the legal position relating to collateral in Finland and should not be relied on as such.

The position is stated as of December 1999.

This summary, prepared by the Collateral Law Reform Group, does not necessarily represent the views of ISDA or any of its members. It is a subjective assessment of the position in Finland and is simply intended to encourage debate and discussion of the relevant issues.

KEY POINTS FOR CONSIDERATION FOR FINLAND

- (1) The owner of a share in a pool of Fungible Securities would have absolute title to the assets.
- (2) The *lex loci* of Fungible Securities held through an account in a clearing system is the place where the account is held.
- (3) Conflicts of law rules would probably apply the *lex loci* to a holding or the transfer of Fungible Securities and the creation and perfection of a security interest in Fungible Securities.
- (4) If security assets are held by a third party bank or custodian the security interest must be notified to the third party and registered on the account.
- (5) No official registration of a security interest with any state agency is necessary.
- (6) A pledgee may not use pledged assets as its own property.
- (7) Formal procedures apply to enforcement of a security interest but may be varied by agreement.

- (8) Enforcement of a security interest may sometimes be delayed by one month and is stayed on insolvency.
- (9) Title transfer arrangements will be recharacterised.
- (10) Close-out netting under an ISDA Master Agreement is enforceable.
- (11) Contractual set-off is not enforceable on insolvency.
- (12) Third party claims will not disrupt set-off and netting between solvent counterparties.
- (13) Top-up collateral for certain financial transactions will not be avoided as a preference. Top-up collateral may be avoided in other circumstances.

1. Do the laws of Finland deal clearly with the nature of a participant's interest in a holding of Fungible Securities?

Yes: see below.

2. How would such an interest be characterised under those laws?

With regard to interests in securities in a book-entry system (that is in dematerialised or immobilised form) it should be noted that according to the Finnish Acts on the Book-Entry System (17.5.1991/826) and on Book-Entry Accounts (17.5.1991/827) (as amended), the main interest in a book-entry account is absolute title to the assets. Therefore, the interest in the securities would, under Finnish law, be characterised as absolute title to the securities. Finnish law does not recognise any forms of divided ownership (beneficial owner etc.).

Besides absolute title, there are certain other rights that may be registered on a book-entry account. First, a book-entry account may include an entry registering a pledge of the account. Such a pledge would cover all assets in the account.

Second, a proxy or a right to operate an account may be registered including an unrestricted right to transfer book entries from the account, the right to obtain information regarding the contents of the account and the right to receive income or other payments made with respect to assets held in the account. Such rights will arise as a result of an agreement with the owner of the account.

There has been a gradual shift from certificated securities to book-entry securities since August 1, 1991, when the legislation creating the Finnish Central Securities Depository (FCSD) came in to effect. Most activities relating to the book-entry system are centralised at the Finnish Central Securities Depository (FCSD), which provides national clearing and registration services for securities. The FCSD maintains a central book-entry securities system for both equity and debt securities.

In order to effect entries in the book-entry securities system, a security holder must establish a book-entry account with the FCSD or with an independent registrar such as a credit institution.

3. **How would the location of Fungible Securities be determined under the laws of Finland?**

With regard to cash and the various forms of Fungible Securities, the location of the relevant assets would, in our view, be determined as follows:

- (i) cash in a bank account would generally be considered to be situated in the place of the debtor regardless of any choice of law clauses;
- (ii) with regard to a pledge of certificated securities, it is likely that such securities would be considered situated in the place where the certificate is located;
- (iii) with regard to a pledge of dematerialised securities recorded in a book-entry system, the assets would likely be considered located at the place where the register recording the owner's interest in the securities is located; and
- (iv) with regard to a pledge of immobilised securities (securities held in certificated form, including a global note, in a clearing system) it is likely that such securities would be considered situated in the place where the relevant certificate is physically located.

4. **Under Finland's conflict of laws rules, what law would govern?**

With respect to the creation and perfection of a pledge over movable property, Finnish rules of private international law are not fully developed. However, Finnish legal authorities generally state that the formalities regarding the perfection of a valid pledge should be determined by the *lex situs*, that is, the law of the place where the relevant property is situated at the time of the contract. Should the assets be considered located in Finland, there are certain actions under Finnish law that are necessary to ensure the formal validity and priority of a pledge as against the interests of third parties (see comments under Question 6).

The *lex situs* would, in our view, also apply to the effectiveness and formal validity of a transfer of title to Fungible Securities (see comments under Question 9).

5. **What types of security interest may be created under the laws of Finland in:**

- (a) **cash?**
- (b) **Fungible Securities?**

Where more than one type of security interest is possible, please indicate which type(s) would typically be used for collateral arrangements involving cash and/or Fungible Securities, and why.

As indicated above, the main type of security interest that may be created over cash or Fungible Securities is a pledge.

In addition, under the Finnish Act on Company Floating Charges (24.8.1984/634, as amended), a floating charge may be created as a form of security over the movable assets of a company, including receivables, securities and book-entry accounts. In the event of bankruptcy, a claim secured by a floating charge has priority over other receivables only up to 50 % of the value of the charged assets. The security value of a floating charge may thus be inadequate.

Pledges over securities, book-entry accounts and receivables have priority over a floating charge even if the pledge is created after registration of the floating charge.

6. In relation to each of these types of security interest, describe briefly any filing, registration, notification, notarisation or other formal requirement necessary to ensure validity of (or “perfect”) the security interest? In relation to each type of security interest, please indicate the consequence of failing to comply with the relevant requirement.

Under Finnish law, there are certain formal requirements that must be fulfilled ("perfection") in order to establish a valid and effective pledge over cash and Fungible Securities. If the pledge has not been duly perfected through, *inter alia*, a transfer of possession, the pledge is not binding on third parties.

Cash

Pursuant to the Finnish Promissory Notes Act (31.7.1947/622, as amended) (the "Notes Act"), promissory notes are divided into non-negotiable or ordinary notes payable only to the person named on the note and negotiable notes payable to "bearer" or "to order".

Under Finnish law loan receivables are treated in the same way as ordinary promissory notes. This also applies to account receivables. Accordingly, monies standing to the credit of a bank account are considered to be a receivable from the bank and when a pledge is created over cash in the account the actual object of the pledge consists of the receivable.

A pledge of a receivable is valid and effective against the successors and creditors of the pledgor provided that the pledge is notified to the person from whom the receivable is due, (for example, the bank in connection to the pledge of an account). This applies regardless of what currency is used.

Certificated Securities

A valid and effective pledge over certificated securities is perfected by the transfer of physical possession of the securities. In other words, the property must be physically removed from the pledgor's possession to constitute a valid pledge. Priority as regards third parties is achieved through transfer and possession of the relevant security. This applies, among other things, to protection against loss of title, for example protection against a claim by a prior owner as a result of a fraudulent disposal, and protection against successors in title and creditors of the pledgor/debtor.

Fungible Securities

According to the Act on Book-Entry Systems, title and rights to shares in Finnish companies, or in a pool of bonds and debentures, or combinations thereof, and rights of participation in collective investment funds, may be recorded as an entry in a book-entry account.

Perfection of a pledge over a book-entry account requires that the pledge is registered as an entry in the relevant book-entry account. It is the duty of the pledgee to apply for registration having received written authorisation from the owner of the account (such authorisation is usually given in the pledge agreement). Only one pledge may be registered over a single book-entry account. All securities held in the pledged account are subject to the pledge. The relevant moment as from which the pledgee is protected against third parties is the actual time of registration of the pledge in the book-entry account.

- 7. In relation to each type of security interest, indicate whether the collateral receiver is entitled to use the collateral as though it were the absolute owner of the collateral, including the right to sell, lend or re-pledge (rehypothecate) the collateral to a third party.**

Under Finnish law, the pledgee is not the owner of the pledged assets and he may sell the pledged assets only in the specific circumstances described briefly under question 8 below. Neither is the pledgee entitled to use the pledged assets or to lend the assets to a third party without the consent of the pledgor. Under Chapter 10 Section 6 of the Finnish Commercial Code (which initially came into force in 1734), a pledgee is under a general obligation to take reasonable care and to ensure the safe custody of pledged assets in its possession.

Notwithstanding the above, a pledgee is entitled to re-pledge the pledged assets to a third party as security for its own liabilities according to Chapter 10 Section 6 of the Finnish Commercial Code. The re-pledge shall be subject to the same conditions as the initial pledge (for example the security assets should not be valued at a higher amount). The initial pledgor (the owner of the pledged assets) must be notified of the re-pledge.

It should be emphasised that securities held in a book-entry account may not be re-pledged.

- 8. Briefly describe the enforcement procedures for each type of security interest commonly used for collateral in relation to financial activity. For example, is court approval required before the security interest may be enforced and/or is some form of auction procedure required. Indicate any practical difficulties typically encountered and also the relative efficiency and speed (or lack of same) of such procedures. Comment in particular on the possibility of a stay or freeze in the event that the collateral provider is subject to formal insolvency proceedings of any type.**

A pledgee is entitled to liquidate collateral consisting of cash or Fungible Securities pursuant to Chapter 10 Section 2 of the Commercial Code (as amended in 1988/ 15.7.1988/687) if:

- (i) the secured liability is due;
- (ii) after the secured liability has become due, the owner of the pledged assets (the pledgor), has been notified that unless the secured liability is settled within a certain time period (being not less than one month), the collateral will be sold; and
- (iii) the time period set out in the notice has elapsed without settlement of the claim.

No court judgement is required for enforcement of a security interest, nor does the relevant section of law, Chapter 10 Section 2 of the Commercial Code, provide for any particular method of enforcement. Chapter 10 Section 2 of the Commercial Code is not mandatory and may be varied by agreement between the parties.

Please note that the commencement of corporate restructuring proceedings will result in a period of protection, during which no debts that arose before the proceedings may be paid, collected, or enforced. Any action in violation of this prohibition will be deemed invalid. During the period of protection, a pledge may not be enforced.

- 9.a. In relation to local law collateral arrangements based on transfer of title, please indicate whether there is a risk that the courts of Finland would recharacterise the transfer of title as the creation of a form of security interest? If so, please give some indication of the degree of that risk (for example, very low, low, medium, high, very high). Please indicate the consequences of such a recharacterisation.**

Finnish jurisprudence takes a negative view of transfer of title as a means of providing collateral. Transfer of title for such purposes is subject to risks which limit its function and value.

In various cases decided by the Finnish Supreme Court, transfer of title to collateral has been deemed ineffective in relation to competing third parties (for example, other creditors of the insolvent) on the basis that the true intention of the parties was to create a security interest. Notwithstanding the above, it has been argued in Finnish legal literature (with some support in case law) that if the formal requirements for the perfection of a valid pledge (see comments under Question 6 above) have been observed, a transfer of title could be recharacterised as a valid pledge. The transferee would thus not be deprived of all his rights to the transferred assets but would be entitled to the interests of a pledgee.

- 9.b. If the agreement is governed by a foreign system of law that does not recharacterise, would the risk of recharacterisation under domestic law still be present?**

As stated above (Question 4), the formalities regarding the perfection of a valid pledge as well as the effectiveness and formal validity (*ultra partes*) of a transfer of title under the Finnish conflicts of laws rules, is determined by the *lex situs* of the assets: that is the law of the place where the relevant property is situated at the time of the contract. Thus should the transferred assets be located in Finland the parties must comply with any formal steps (transfer of possession etc.) required by Finnish law, regardless of any choice of laws. Accordingly, a transfer of title as a form of security may be recharacterised as a pledge even if the agreement is governed by a foreign legal system that does not recharacterise. The deemed location of assets is discussed under Question 3.

- 10. Is close-out netting, for example, under a 1992 ISDA Master Agreement, enforceable under the laws of Finland? If so, but subject to certain limitations (for example, as to the nature of the counterparty or types of transaction included within the netting), please indicate briefly what those limitations are.**

Legislation concerning the validity and enforceability of netting agreements came into force in Finland on July 1, 1997. The Act on Certain Terms in Securities and Foreign Exchange Transactions (19.6.1997/588, as amended) ("Netting Act") clarifies the position of close-out netting under Finnish law. In addition, by virtue of the Netting Act, security arrangements relating to financial transactions (as defined in the Netting Act) are enforceable even in the event of the insolvency of one of the parties to an agreement. The new legislation also implements European Directive 98/26/EC of May 19, 1998 Directive on Settlement Finality and Collateral Security (the "Settlement Finality Directive").

Under the Netting Act, close-out netting of the type provided in Section 6 of the 1992 ISDA Master Agreement is enforceable under the laws of Finland assuming that the parties to the Master Agreement have selected the Second Method as payment method and either Market Quotation or Loss as the payment measure. The First Method as set out in Section 6(e) of the 1992 Master Agreement would not be enforceable under the laws of Finland.

It is unclear whether the Netting Act would apply to bullion transactions, credit protection transactions or to a total return swap. In this respect the type of transaction from which the creditor's exposure results may affect the creditor's enforcement rights.

See also the netting opinions provided to ISDA by Hannes Snellman of March 1998 and November 1998.

- 11. Is contractual set-off and/or insolvency set-off enforceable in the event of formal insolvency proceedings in the courts of Finland in relation to a counterparty organised in Finland? Please indicate the answer in relation to each type of formal insolvency proceeding (including rehabilitation or reorganisation proceedings such as administration or *redressement judiciaire*) possible in Finland in relation to a corporate entity (including a financial institution). Comment in particular on the possibility of a stay or freeze in the event that the collateral provider is subject to formal insolvency proceedings of any type.**

Under Finnish law there are three main conditions which must be fulfilled for set-off to be valid on insolvency. In order to set off receivables, the claims must be

- a) similar in nature (which means basically that only money claims may be set off against each other);
- b) enforceable; and
- c) mutual (in the sense that each party to the set-off is concurrently both a creditor and a debtor with regard to the other);

Set-off in the event of bankruptcy is subject to these general conditions. In addition, a further specific condition prescribed by Section 33 of the Bankruptcy Act and must be fulfilled. In order to set off a debt owed to the bankruptcy estate with a counter claim against the bankruptcy estate, both claims must originate prior to the commencement of the bankruptcy proceedings.

Restructuring Act

Under the Finnish Act on Restructuring of Companies (25.1.1993/47, as amended) ("Restructuring Act") the making of an order for restructuring proceedings to commence will result in a period of protection, during which any right to set off receivables with respect to the company under restructuring is prohibited. The period of protection remains in force until a restructuring proposal, covering all the debts and assets, including pledged assets, is approved by the company and a court order made or alternatively, when the restructuring proposal is rejected by the court and the company is placed into bankruptcy.

Credit Institutions

The provisions of the Restructuring Act do not apply to credit institutions (including banks). Moreover, the bankruptcy proceedings of such institutions are only partially governed by the Finnish Bankruptcy Act. Special provisions regarding insolvency of the different forms of credit institution are included in the Commercial Bank Act, the Savings Bank Act and the Cooperative Bank Act respectively. The insolvency provisions in each Act are similar in substance.

In the event that the auditors of a credit institution or the Finnish Financial Supervision Authority make specific findings (proscribed in detail in the above acts) regarding the financial soundness and solvency of the relevant credit institution, the Ministry of Finance may order a credit institution to suspend acceptance of deposits from customers, the

withdrawal of funds from any accounts and settlement of any other liabilities. Such an order may be imposed for a maximum of four months.

After the operations of a credit institution have been suspended, no proceedings against the credit institution for the enforcement of debts or other liabilities may be commenced. Although not expressly provided by law, it is likely that any right of set-off is also stayed once the operations of a credit institution have been suspended.

Netting Act

It should be emphasised that the Netting Act creates a significant exception to the restrictions imposed by the above insolvency regulations. The Netting Act allows the netting of certain financial obligations despite the commencement of bankruptcy proceedings or of restructuring proceedings in relation to a company or any suspension of business in relation to credit institutions. The main prerequisite for netting is that the netted obligations originated prior to the commencement of the relevant proceedings.

- 12. Would the exercise of netting or set off rights under a title transfer collateral arrangement be vulnerable to the rights of third parties in the event of the insolvency of the collateral giver? For example, would it be possible for the collateral giver to disrupt (deliberately or inadvertently) the netting or set-off by assigning to a third party creditor its right to redelivery of equivalent collateral under the collateral arrangement? Could that right to redelivery be attached by a third party creditor of the collateral giver free of the collateral taker's netting or set off rights under the collateral arrangement?**

The Finnish Netting Act also applies to collateral security provided (under a pledge) to a clearing organisation or a contractual party in connection with certain financial transactions (as defined in the Act) entered into, for example, under the 1992 ISDA Master Agreement including transactions in investment instruments as defined in Section 2 of the Investment Firms Act (26.7.1996/579, as amended) and in other comparable securities and derivatives; currency transactions; and any payments related to securities. The Netting Act expressly permits close-out netting and creates specific exceptions from general insolvency and corporate recovery laws.

Under Finnish law it is generally possible to transfer rights to third parties. However, an agreement may incorporate a clause prohibiting assignments in which case contractual rights (such as the right to delivery) may not be transferred to a third party. It should be noted that pursuant to Section 5 of the Finnish Act on the Recovery of Assets for the Bankruptcy Estate (26.4.1991/758, as amended) (the "Recovery Act") any transfers could be set aside in the event of restructuring or bankruptcy proceedings.

- 13. In relation to mark-to-market collateral arrangements, is there any risk under the preference (or similar) rules of Finland that "top-up" deliveries of collateral would be vulnerable to avoidance if made during a relevant period prior to the insolvency of the collateral giver?**

Even if a pledge has been perfected in accordance with the law and is valid in all relevant aspects, the pledged assets may be recovered for the benefit of the bankruptcy estate in certain circumstances pursuant to the Recovery Act. The rules of the Recovery Act apply *mutatis mutandis* to execution procedures under the Execution Act (3.12.1895, as amended) and to company restructurings under the Restructuring Act.

With regard to the above insolvency procedures, the following rules in particular are relevant:

- (i) Section 14 of the Recovery Act concerns the recovery of pledged assets. This provides that any security for the bankrupt's debt given within the three (3) months prior to the commencement of bankruptcy proceedings shall be liable to recovery from the creditor if, inter alia, the pledge was not agreed in connection with the granting of new credit.

Should the parties to the pledge agreement be considered closely connected as that concept is defined in the Recovery Act (for example, entities with strong mutual interests such as companies within the same group) the relevant look-back period would be extended to two years. In this case the pledged assets would be recovered unless the debtor was solvent at the time of the granting of the pledge and did not become insolvent as a result.

- (ii) Section 5 of the Recovery Act sets out general rules relating to the recovery of assets and covers all transactions between the insolvent debtor and a counterparty, including security arrangements. Section 5 provides that any transaction agreed within five (5) years prior to the commencement of bankruptcy proceedings shall be set aside if the transaction, either on its own or together with other transactions improperly preferred one creditor to the detriment of other creditors or increased the company's liabilities. Moreover, it provides a general prerequisite that the company was either insolvent or became insolvent due to the transaction and the creditor either knew or should have known of these circumstances. Pursuant to Section 5, if the parties to the transactions are closely connected, the applicable look-back period would be unlimited.

It should be emphasised that the Netting Act creates an exception to Section 14 of the Recovery Act. Under the Netting Act, deliveries of collateral will not be subject to avoidance pursuant to Section 14 provided that the collateral provider is a party to a financial transaction (such as a derivative transaction, securities trading, or a securities repurchase transaction) and is liable, under the terms of the relevant financial transaction, to transfer collateral and/or additional collateral and this collateral and/or additional collateral has been transferred without unreasonable delay.

14. Please add any additional comments on the general legal framework for collateral arrangements under the laws of Finland, whether based on creation of a security interest or on title transfer, highlighting any difficulties that should be addressed in any project for collateral law reform in Finland.

Under Finnish law, corporate insolvency is governed mainly by the Bankruptcy Act of 1868 (as amended), the Restructuring of Companies Act of 1993 (as amended) and the Act on Recovery to Bankruptcy Estate of 1991 (see above under Question 12). The restructuring and bankruptcy of credit institutions is subject to special regulations, namely various banking laws, including the Act on Credit Institutions (1607/1993, as amended), the Commercial Bank Act (1269/1990, as amended) and the Cooperative Bank Act (1271/1990, as amended).

The following points in particular raise possible concerns:

- *Recharacterisation.* Recharacterisation risk is present in relation to title transfer arrangements
- *Close out netting.* Close out netting may not be available in all circumstances.

- *Insolvency set-off.* There are limitations on the availability of insolvency set off
- *Freezes.* Upon restructuring of a corporate, or suspension of the business of a credit institution, a freeze is imposed during which security interests cannot be enforced or rights of set-off be exercised.

The Collateral Law Reform Group acknowledges the assistance of Hannes Snellman, Helsinki in the preparation of this report. That firm, however, accepts no liability in relation to this report.