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HEXIM RESPONSE TO CONSULTATION ON ESCB-CESR STANDARDS FOR SECURITIES CLEARING AND SETTLEMENT SYSTEMS IN THE EUROPEAN UNION

1. General issues

ESCB and CESR have called on European interest groups to provide input to the consultation on proposed ESCB-CESR Standards for Securities Clearing and Settlement Systems in the European Union published on 1 August 2003.

1.1 HEX Integrated Markets

On September 4, 2003, OM and the Finnish exchange operator HEX merged to form OMHEX. OMHEX is made up of two divisions: OM Technology and HEX Integrated Markets.

HEX Integrated Markets is northern Europe's largest securities market. Through its exchange operations within Stockholmsbörsen, HEX Helsinki, HEX Tallinn and HEX Riga it offers investors access to 80 percent of the Nordic equity market and 75 percent of the Baltic equity market. HEX Integrated Markets also operates CSDs in Finland, Estonia and Latvia. HEX Integrated Markets has invited the other Nordic and Baltic exchanges and CSDs for even further integration.

HEX Integrated Markets has annual revenues of 1,820 MSEK (2002) and 400 employees in Finland, Sweden, Estonia and Latvia. Headquarters of HEX Integrated Markets is located in Helsinki, Finland.

In respect of OMHEX, the proposed standards will, at minimum, affect the CSDs in Finland, Estonia and Latvia, the derivatives clearing houses in Sweden and in Finland as well as back-office, custody and outsourcing services provided by OM Technology within the Banks and Brokers business area. OMHEX takes also great interest in Nordic CCP development.

Our response focuses on the Finnish, Swedish and EU market environment, but the answer is provided also on behalf of our operations in the Baltics.

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Having participated in producing the ECSDA and EACH responses, we subscribe to them entirely.

1.2 Approach to the standards

In general, we welcome the proposed standards as a warranted step towards more efficient and secure European clearing and settlement framework. We agree that there is a need to modify the global CPSS/IOSCO recommendations to reflect the European and single currency environment.

We appreciate the aim to curb down the increase in the regulatory burden. Before introducing the standards, ESCB and CESR should ascertain that at least CPSS/IOSCO disclosure framework of 1997, recommendations of 2001 and ESCB (EMI) standards for the use of EU Securities Settlement Systems in ESCB Credit operations of 1998 with their respective disclosure requirements and assessment criteria will in fact be replaced by the new standards. Furthermore, we believe that CESR and ESCB should work with their U.S. counterparts to establish the new standards as the main assessment framework for European institutions also from the U.S. perspective.

We support the functional approach adopted in the standards as opposed to the institutional approach. The standards reflect the functional approach better than previous initiatives. We believe that in the current situation with diversified structures and with rapidly evolving processes and roles, any other approach would miss the targets set for the standards. ESCB and CESR should preserve this approach and it should be adopted even in further regulatory developments, such as in the conceivable framework directive.

The institutions sometimes categorized as CSDs in Europe differ to a significant extent from each other, not to mention from the ICSDs. A general definition for a CSD focusing on what is common for that type of institutions in Europe would be detrimental for the market and for development if it was applied by setting institutional roles and restricting activities of such institutions. We don't think it is necessary or even advisable to try to define CSDs or settlement systems by way of restrictions but rather by providing examples to the extent such definitions are necessary at all when applying the functional approach. We have noted that ESCB and CESR have conceded to this approach.

We wish to point out that the principle of level playing field necessitates simultaneous and equitable implementation of the standards both in terms of the entities to which the standards are applicable and in terms of jurisdictions in which they are adopted. The ESCB and CESR should work out ways which will ensure uniform interpretation and application of the standards across jurisdictions and with respect to the different entities (CSDs, CCPs, custodians operating systemically important systems and custodians with dominant position) that are subject to the standards.

2. Scope of application of the standards (Issues to be addressed)

On the specific question as to the scope of application, we wish to provide the following answers:

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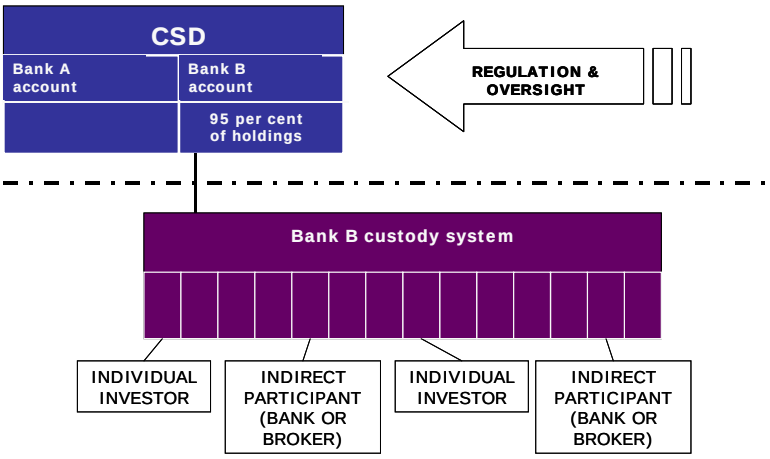
1. Do you agree that some of the scope of the standards should be extended to systemically important providers of securities clearing and settlement services other than CSDs and CCPs?

Yes we do. ESCB and CESR have addressed a very important area of risks in the clearing and settlement environment by applying the logics of the functional approach.

The flaws of the institutional approach can be illustrated by an imaginary example of a market in which there are only two participants in a CSD with the other participant controlling 95 per cent of the holdings:

Institutional approach:



It is evident from this example that if regulation aiming at addressing both investor protection and systemic issues will only focus on the CSD due to institutional reasons, it would be missing its target, as everything relevant in that market takes place in Bank B custody system.

It shall be noted that for very similar reasons as contemplated in the ESCB/CESR proposal, the Finnish central securities depository and the credit institutions were subjected to identical contingency requirements in a recent revision of the Finnish Emergency Powers Act (1080/1991).[1]

2. Should the extension be to all custodians, or should it be limited to systemically important providers of securities clearing and settlement services?

The systemic reasons warrant the limitation to systemically important institutions, while, from the investor protection point of view, a more extensive application might be justified. We wish to note, however, that in practice market pressure can lead to a more general application of the standards as an official benchmark. The market participants are facing an increasing focus by the customers on risks,

[1] See Act no 482/2003 and no 484/2003.

which may lead to an accelerating flight towards quality instead of a race to the bottom. Thus, the rules may very well trickle down to other custodians than just the systemically important ones in practice.

3. What are the criteria along which - according to your opinion – the systemically important system could be defined? What would you consider to be the essential elements that should be apart of such a definition?

We are of the opinion that the criteria should be rough enough to facilitate implementation of the standards while being objective and predictable. The example taken by ESCB and CESR from the U.S. Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S Financial system is warranted also in the European context. It should be feasible to define the data from which the triggering market share is calculated. The central banks and regulators already have access to relevant information from this perspective and where this is not the case, such access should be granted.

We believe that ultimately it is the authorities in each jurisdiction that are best capable to determine, based on a common objective assessment criteria, which institutions would be subject to the standards.

4. Do you agree that systemically important providers could be defined as institutions with a business share of [5%] at EU level or [25%] at domestic level (or lower, at the discretion of the national authorities) in each relevant market?

We do agree with the proposal. The systemic issues shall be addressed independently on the EU level and on the domestic level. An institution may cause systemic disturbances in a member state or in some member states while its impact on the European market as a whole may be manageable.

We also suggest for consideration non-quantitative criteria. For example, all CCPs or Securities Settlement Systems designated by regulated markets should be covered with the standards. Also all institutions acting as general clearing members for other participants should be included. Furthermore, credit institutions acting as payment agents for participants in settling the cash leg may need to be covered.

5. Do you agree that three relevant markets can be considered – bonds (public and private), equities and derivatives – or would a different categorisation be helpful?

In general, we agree with the distinction. It should be assessed, however, in which category and in which way the money markets and their settlement systems would be included. For this reason we propose to use the concept of fixed income market instead of bond market.

Furthermore, in light of the recent events it may be warranted to distinguish between financial derivative markets and commodity derivative markets.

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6. Which of the ESCB-CESR standards should apply to all systemically important custodians?

We think that at least standards 1, 2, 3, 4, 5, 7, 8, 9, 11, 12, 14, 15 and 16 should apply to systemically important custodians in order to promote the aims behind the standards. However, as regards credit risks contemplated in standard 9, we think that in accordance with the functional approach, such risks should be addressed in the general regulatory framework concerning such function, i.e. the Basel Accord and current EU law on capital adequacy.

7. What would be the implications of extending the scope of the standards to cover systemically important providers of securities clearing and settlement services?

In our opinion, the extension would upgrade security and efficiency in the European clearing and settlement environment. Furthermore, it would enhance both systemic resilience and investor protection. The standards would facilitate establishing a level playing field for diverse entities performing the same or similar functions.

8. Do you agree that standards 13, 14, 15 and 17 should apply to custodians with a dominant position in one market? If yes, how would you define a dominant position?

See our answers above.

3. Specific comments on the individual standards

Standard 1: Legal framework

We agree that a robust legal framework is a precondition for control and mitigation of risks relating to clearing and settlement. We anticipate that a proper legal framework for cross border transaction processing will ultimately require harmonization measures such as envisaged in the second Giovannini report (EU Account Certainty Project) and in the Unidroit study group position paper on harmonized substantive rules regarding securities held with an intermediary. Measures relating to legal framework fall for the most part within the ambit of governments and legislators, however, as correctly recognized by ESCB and CESR.

In paragraph 29 we have noted a new, in-depth disclosure on legal framework to be provided by the institutions covered with the standards. The issues to be addressed in the disclosure or opinion are to our mind more warranted than for example the Terms of Reference used by ESCB when assessing the CSD links. ESCB and CESR may recognize, that it may be difficult or costly to acquire satisfactory external legal opinions to such extent as envisaged in the standards. This is due to the fact that in order to cap liability, external counsels need to qualify their opinions. A disclosures provided by internal resources may thus prove to be more appropriate in terms of transparency and depth. It should be expressly stated in the standard that internal analysis is sufficient to fulfil the disclosure requirement.

Paragraph 34 provides that as a rule only one legal system should be chosen to govern the proprietary aspects of all securities held on the participants accounts. This may prove to be controversial in case a number of depositories are grouped in under one structure in which

a depository can act as an agent for others providing access to accounts in all depositories belonging to the same group. In that case the parties should be able designate the proprietary law of each country in question although the contractual aspects of the agreement would be governed by one law. We think that this is facilitated under the Hague PRIMA convention.

Standard 2: Trade confirmation and matching

We have no major concerns with this standard.

Standard 3: Settlement Cycles

With regard to cross-border interoperability and efficient operation of the links, we endorse the aim to unify settlement cycles and operating hours of clearing and settlement systems across Europe.

Standard 4: CCPs

We welcome the general standards for CCPs while, on the other hand, we note that the regulatory framework for European CCPs will remain under constant modification process in the medium term as CPSS/IOSCO will first draft recommendations with assessment criteria and ESCB/CESR will then amend them into standards.

Standard 5: Securities lending

We have no particular concerns with the standard.

Standard 6: CSDs

The content and impact of the standard has changed from the CPSS/IOSCO recommendation that highlighted safety by promoting immobilisation and dematerialization as means to control risks. ESCB/CESR have turned this recommendation into a standard that may have the effect of restricting activities of certain institutions in contradiction with the functional approach. In the spirit of the functional approach, the standard should not be interpreted to categorize institutions let alone restrict their operations.

Instead of saying "CSDs should avoid taking risks to the greatest practicable extent." the standard should provide that "entities performing functions relating to securities issuance, management of the issue and transfer of securities through book entry should identify the risks relating to such function and set up controls to mitigate such risks to the greatest practicable extent. When identifying such risks, the other functions performed by such entity should be addressed to protect the securities issuance, management of the issue and transfer of securities".

As to key element 2, we think it is warranted in the European context for ESCB and CESR to give a clear preference to dematerialization over immobilization as means of controlling overall risks in the systems. This preference should be declared in the standard. All of the systems included in HEX Integrated markets operate on the basis of dematerialization.

As we have pointed out above, we don't think it is reasonable to provide a general definition for a CSD focusing on the least common denominator between institutions. European CSD institutions have been vested with a number of different functions either by law or through outsourcing which don't belong to the categories set forth by ESCB/CESR as

"core activities" in para 76 and 77. Within the functional approach it seems redundant to try to define core activities of a CSD. Such definitions would be detrimental to the development of the market, should they be interpreted in a way of restricting operations that an institution can perform.

As to paragraph 81 describing the direct and indirect holding structures, we encourage ESCB and CESR express their views about the risk impact of the different structures. For our part we recognize a clear difference in risks associated with each structure.

In our opinion, the structure of the Nordic book-entry system, which facilitates direct investor accounts combined with automatic and efficient registration in the shareholder lists, suits well the growing needs of issuers and investors. In the Finnish CSD system, a transaction can be settled all the way to the direct account of the individual investor. We are able to settle 99,62 per cent (in September 2003) of Helsinki Exchanges trades in the standard settlement cycle of T+3 measuring the timeliness from credits in direct accounts. In most other systems, corresponding measures are taken from settlement on the mere level of the clearing parties/intermediaries.

In indirect systems, the depository and the issuer only recognize the intermediaries who hold securities for investors or other intermediaries. In such systems investors' rights are derived from a pooled holding of securities, and the rights do not add up to a direct ownership. We feel that the risks associated with indirect systems are rarely subject to sufficient consideration or debate since the major markets operate under indirect structures. The ultimate risk of loss due to commingling, fraud or system errors belongs to the nature of indirect systems.

Due to their nature, indirect systems may only operate under loss-sharing rules. There is also a possibility that investors may lose their holdings in the insolvency proceedings of an intermediary due to pooling of securities in the bankruptcy proceedings (ref. UCC § 8-503, US Bankruptcy Code and Securities Investor Protection Act). In Nordic systems, such risks are mitigated and even abolished to large extent. In our opinion this is one of the reasons why e.g. Swedish and Finnish systems tend to rank in top ten both in Europe and globally in e.g. the Thomas Murray risk ratings.

Standard 7: DvP

We have no major concerns with the standard. It may be appropriate to examine the standard even with respect to payment and settlement related to subscription of shares. This process and risks associated with it do not differ in their essence from the risks relating to clearing and settlement of trades. We wish to note that the Nordic direct holding structure facilitates safe DvP -style processing of subscriptions.

Standard 8: Timing of Settlement Finality

We have no objections to the standard.

Standard 9: Risk controls

The standard addresses credit risk, although the wording of the first sentence of the standard may give rise to a broader interpretation. In our opinion, the requirement to collateralize credit risk fully may be problematic with regard to the development of the market (key element 3), while we recognize the objective to mitigate risks. In accordance with the functional approach, such risks should be addressed in the general regulatory

framework concerning such function, i.e. the Basel Accord and current EU law on capital adequacy.

We note also that the existing law may already provide sufficient tools to address the prospect about which ESCB and CESR seem to be most concerned, namely the capability of a CSD and a custodian to continue settlement in financial disturbances and insolvency. The Finnish Act on the Book-Entry system Section 12(2) and 9(5) (which have been elaborated in more detailed contingency planning by APK and Finnish authorities) provide that:

- when the license of the Central Securities Depository has been withdrawn, the Council of State may issue further orders on the handling or transfer to another organization of the duties of the Central Securities Depository; and
- when the rights of a participant (account operator) have been withdrawn, the operations carried out by the account operator shall immediately be transferred to be attended to by the Central Securities Depository.

Consequently, resilience and continuity seem to us to relate more to requirements on contingency planning than credit risk. Should insolvency not be covered by current business continuity plans, the plans should be updated.

We also refer, again, to the recent amendments to the Finnish contingency planning legislation. The Finnish central securities depository and the credit institutions have been subjected to identical contingency requirements in a recent revision of the Finnish Emergency Powers Act (1080/1991). The reasoning behind this solution is functional.

Standard 10: Cash settlement assets

We endorse the principle that from the systemic viewpoint all significant settlement should be performed using central bank money. However, in cross-border context it should be recognized that commercial bank money must continue to be considered as a viable options unless the practice and the rules in the Eurosystem are changed and as long as the linked systems need to accommodate to different currencies.

Standard 11: Operational reliability

In our opinion this is one of the most important standards to be applied in a unified manner to custodians performing systemically important settlement functions and to CSDs. As maintaining operational contingency and resilience is a considerable source of cost, the standard promotes level playing field, while reducing risk at the same time.

Standard 12: Protection of customers' securities

We agree that special attention shall be paid to protection of customer assets. In direct holding systems, the system allows investors to hold investor-specific accounts on the level of the Central Securities Depository. Respectively, the investors may be entered into the books of the issuer without using a nominee construction. In these jurisdictions*, direct holdings on the level of the CSD and in the books of the issuer are widely regarded as the safest form of securities holdings. All subsequent layers of intermediaries represent an increase in the custody risk. This principle has been reflected in the Standards for

* Examples for such jurisdictions are the Nordic countries, i.e. Sweden, Denmark, Norway, Finland and Iceland, as well as Estonia and U.K.

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Securities Settlement Systems used in the Monetary Policy Operations of the European System of Central Banks.

We also refer to our response concerning standard 6, para 81.

Key element 6 and para 141 of the standard may be interpreted to question the validity of the collateral arrangements facilitated and promoted in the Collateral directive to be implemented in Member States by the end of this year. The standards should be without prejudice to the simplification of the use of financial collateral and the forms of collateral (right of use in particular) provided under the Collateral directive. Therefore we propose that a reference to this effect is inserted in the key element and in para 141.

Standard 13: Governance

In terms of governance, ESCB and CESR should recognize explicitly that CSDs, CCPs and custodians are not primarily public law institutions performing government functions but predominantly private companies in which governance principles flow from general company law. Pursuant to these principles, the board and the management are responsible for the shareholders in the first place. This principle should not be prejudiced albeit the importance of these functions for the society.

In the same vein, para 148 seems to suggest that there should always be independent board members on the immediate level of the CSD, CCP or custodian company. Consolidated groups have not been expressly observed. However, it is ordinary to have external board members primarily in the group level board while subsidiary boards are occupied by executive members. This is a corollary of the primary responsibilities of a board and of management in a consolidated group. There is only one meaningful sphere of shareholders in a consolidated group of companies and that is on the group level. The standard should recognize the emergence of consolidated group structures and it should be explicitly stated that in such structure independent, non-executive members will usually man the group level board.

Furthermore, para 148 encourages the addressees to establish consultation mechanisms for users (even retail investors) providing that "Full account should be taken of their [user] views". The standard process to amend the rules Finnish CSD rules prescribes consultation by the users subject to the rules. However, it is often impossible to accommodate all user views fully, as they tend to be conflicting. ESCB and CESR should recognize that the ultimate responsibility in maintaining the function lies with the respective entity and that the entity is not entitled to shift that responsibility or relieve itself from it through user consultation. It can be envisaged that current users may object measures facilitating access to the system, but the system operator will have to provide the access anyhow. Tightening competition between the settlement service providers already secures that customer views are taken into account. None of the entities covered with the standard can afford to ignore customer feedback due to business reasons. We propose that the reference to taking account of consultation views be without any prejudice of the sovereignty of a CSD, a CCP or a custodian in respect of maintaining the soundness, efficiency, transparency and accessibility of its system.

We note that a reference to group structure has been included in para 149 addressing the need to control conflict of interests. We endorse the principles highlighted in the paragraph.

Lastly, we wish it to be noted in the standard that the structural development of the ownership of institutions covered by these standards is driven by the market and that ESCB

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and CESR do not intend to intervene in the current processes and ownership structures with the standards.

Standard 14: Access

We have no objections to this standard. We embrace open and free remote access to markets as well as to clearing and settlement structures.

Standard 15: Efficiency

We subscribe to the objective to achieve interoperability by standardization.

Standard 16: Communication and STP

We support the standard on facilitating STP and standardized communication and messaging procedures.

Standard 17: Transparency

We have no major concerns with this standard.

Standard 18: Regulation, supervision and oversight

We have no observations concerning this standard.

Standard 19: Cross-system links

We have no objections to this standard and we welcome key element 6 addressing the risk management and efficiency in relayed links. We also appreciate the proposal in para 204 that the number of systems connected in a relayed link has not been capped in absolute terms to three. As the PRIMA principle has been adopted in the Settlement Finality Directive and in the Collateral Directive as well as in the Hague Convention, the legal robustness of relayed links has been strengthened since the adoption of the ESCB (EMI) standards for the use of EU Securities Settlement Systems in ESCB Credit operations of 1998 (standard 3).

Yours faithfully,

HEX Plc.

Jukka Ruuska
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