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NOTE

from :	Services of the Commission
to :	Committee on Civil Law Matters (Rome I)
No. prev. doc. :	16353/06 JUSTCIV 276 CODEC 1485
No. Cion prop. :	5203/06 JUSTCIV 3 CODEC 18
Subject :	Proposal for a regulation of the European Parliament and the Council on the law applicable to contractual obligations (Rome I)[1] **- Certain financial aspects relating to the application of Articles 4 and 5**

In document 13853/06 JUSTCIV 224 CODEC 1085, the Finnish Presidency introduced a specific rule in Art. 4(1) relating to stock exchange transactions and excluded contracts relating to financial instruments from Art. 5. During the discussions on the subsequent draft proposals the density and complexity of this subject and its importance for the delegations became evident. The services of the Commission consider therefore that it would be helpful to base the debate concerning these difficult and highly technical issues on a document outlining the relevant questions. It is with this aim and in a spirit of cooperation that the services of the Commission submit the present document. For mere reasons of clarity and simplicity the proposed text attempts to highlight the relevant issues by using the form of a draft reformulating the presidency's proposal that is followed by an explanation of the issues at stake. However, it is accepted that the drafting may require further refinement even if the ideas expressed herein are accepted.

[1] COM(2005) 650 final

Article 4

(1)(j1) **a contract concluded within a multilateral system which brings together or facilitates the bringing together of multiple third party buying and selling interests in financial instruments, as defined by Article 4(1)(17) of Directive 2004/39/EC, in accordance with non-discretionary rules and governed by a single law, shall be governed by that law;**

Explanation

In document 6935/07 JUSTCIV 44 CODEC 168, Article 4(1)(j1) the rule on a contract concluded on a financial market has already been separated from the rule on a contract of sale by auction. The nature of these rules is in fact so different that to include them in a single provision would lead to misinterpretation.

The reason for including a specific provision for trading systems relates, in particular, to the fact that regulated markets, multilateral trading facilities and other similar trading systems need to operate under a single law. It is essential that all transactions are carried out in accordance with the governing law of the system. The application of a single governing law is an intrinsic feature of organised multilateral trading systems and necessary for legal certainty for the market participants.

These transactions concluded within such a trading system include contracts of buying, selling, lending and other such dealings in financial instruments. Contracts for the provision of services between a financial intermediary and a client are not concluded within these trading systems.

The transactions in question are closely connected to the market concerned and it is appropriate and, indeed, necessary that the same law governs them irrespective of the nature of the parties to the transactions (consumer/professional) and the place where the parties have their habitual residence. Any other result would mean that the systems could not operate.

Definitions

However, the use of the term "financial market" in this provision leads to undesirable uncertainty. There is no definition of this concept in any community instrument. The term is used in the particular context of Article 9 of the Insolvency Regulation[1] but it is not defined. In the framework of a general conflict of law rule in Rome I this expression would lack precision and create legal uncertainty. Given the extreme diversity and complexity of the financial sector activities, there is a need to define all relevant concepts used.

Taking into account the universal scope of application of Rome I (Art. 2), the definition of markets and trading systems by reference to the EU regulatory categories in Directive 2004/39/EC (MiFID)[2] has been avoided. This is because cross-reference to the MiFID concepts would limit the provisions to an EU context. Instead, the proposed draft contains a functional description of multilateral system that uses the common elements of the definitions of regulated market and multilateral trading facility in MiFID, together with the condition that such systems should be subject to a single governing law. This description will cover all the equivalent non-EU trading facilities that need to be caught.

The proposed draft (see also Art. 5) does, however, make a cross-reference to the MiFID definitions of financial instruments and transferable securities (different concepts). Nevertheless, this does not limit the scope of the provisions to an EU context because the MiFID definitions are descriptive, and (unlike the concept of "regulated market") are not based on regulatory concepts that are exclusive to Community law. The alternative would be to reproduce the text of the MiFID definitions here, but they are lengthy. The MiFID definitions are comprehensive, and cover the whole range of instruments that need to be caught - including those that might be developed in the future, since even the most arcane and ingenious innovations would in principle fall within one of the generic categories mentioned in the list of financial instruments in Annex I to MiFID (options, futures, swaps, forwards, derivatives etc.).

1 Regulation (CE) 1346/2000 on insolvency proceedings, OJ L160 30.6.2000 p.1.
[2] OJ L145 30.4.2004 p.1.

Article 5 (3)(d)

As regards the exclusions from Article 5, three separate issues need to be considered:

- **rights and obligations which comprise a financial instrument, as defined by Article 4(1)(17) of Directive 2004/39/EC;**

- **a contract to subscribe for or purchase a new issue of transferable securities, as defined by Article 4(1)(18) of Directive 2004/39/EC, or units in collective investment undertakings;**

- **a contract concluded within the type of system falling within the scope of Article 4(1)(j1) of this Regulation.**

Explanation

All these issues are not covered by Art. 5 of the Rome Convention as that Article only applies to contracts for the provision of services and sale of goods. The questions discussed in this document only arise due to the enlarged scope of Article 5 of the Rome I proposal.

The proposed text does not exclude contracts for the provision of financial services generally nor does it exclude contracts for the sale of shares and bonds concluded outside the systems referred to in the draft Art. 4(1)(j1).

As regards financial instruments, on the assumption that the exclusion from the scope of the Rome I proposal of financial instrument under Art. 1(2)(d) may not be exhaustive it is absolutely necessary to provide for this exclusion since without it the actual nature of a financial instrument - the rights and obligations that constitute its essence - could change by virtue of the application of Article 5. A financial instrument, legally speaking, is made up of a bundle of contractual rights and obligations which, in the simplest cases, apply between the issuer and holder of the instrument. To take the example of a simple bond, the essence of that bond issued directly by an issuer to a retail customer is actually a contract between the issuer and that customer under which, among other things, the issuer has the obligation to pay and the customer has the parallel right to receive, the principal and interest in accordance with the specified terms of the bond. Without an amendment to this effect, the actual nature of a financial instrument and the rules of law governing it could be various and unpredictable and would depend on the habitual residence of the person holding it.
This question should not be confused with contracts for the provision of financial services. For example, when a bank sells to a consumer shares from company x it is providing a financial service. The consumer friendly rule of Article 5 of the proposal will naturally continue to apply to all these contracts that were already covered by Article 5 of the Rome Convention.

As regards the subscription for shares and units in collective investment schemes, and purchase of new issues of debt, it is important that the issuer in relation to a single issue is not faced with a risk of application of multiple laws depending on the habitual residences of investors. This would effectively prevent cross-border retail offerings of shares, debt, etc. Contractual rights and obligations in relation to the subscription for or purchase of new issues of transferable securities will not necessarily be covered by the narrowly focussed exclusion discussed above for contracts which comprise financial instruments. For example, contractual terms about the allocation of shares, rights in the event of over-subscription, withdrawal rights, or pre-emption rights are not comprised in the financial instrument itself. Rather, they are the subject matter of contract for subscription. By way of further example, the contractual terms for the purchase of a bond would typically include the methods and time limits for the paying up and for the delivery of the securities. Again, such elements are not intrinsic to the bond itself, and would not therefore be covered by an exclusion for rights and obligations comprised in a financial instrument.

Thus, on the assumption and to the extent that this issue is not excluded entirely from the scope of the Regulation by virtue of Art. 1(2)(f) (exclusion of contracts governed by company law) it is necessary to ensure in relation to contracts of subscription for or purchase of a new issue of shares, bonds and other transferable securities that Article 5 does not apply.

The last point concerning contracts concluded within a multilateral system mirrors the specific rule inserted in Art. 4. As stated, the scope of this exclusion is relatively narrow; it does not cover for instance contracts relating to financial advice or custody of financial instruments concluded with a consumer. This would remain in the scope of the main rule in Article 5. This exclusion is essential, for the reasons given above in relation to proposed Art. 4(1)(j1).

Finally, the Committee may wish to consider an amendment to the text or at least a recital in order to clarify that individuals who 'opt up' to professional status under MiFID should not be treated as consumers for the purposes of Art. 5. Annex II to MiFID allows clients of investment firms, who would otherwise be classified as "retail clients" to be treated as "professional" clients if they meet specified conditions aimed at establishing that that client is financially sophisticated and experienced in investment. However, such clients may be considered to fall within the category of "consumers" for the purposes of Art. 5. The point is important since firms would be most unlikely to let sophisticated individuals opt up to professional status if Art. 5 were to apply to their dealings, and accordingly the objectives of the MiFID in this respect would be thwarted.

Proposed recital

"For the purposes of the provisions determining the applicable law to contracts concluded by consumers, natural persons categorised as professional clients on request in accordance with the criteria and the procedure set out in Annex II Section II of Directive 2004/39EC should not be considered as consumers when concluding contracts involving an investment service, transaction or type of transaction or product for which they are treated as a professional client."