

**REGULATION ON THE LAW APPLICABLE TO CONTRACTUAL OBLIGATIONS  
(ROME I)**

**INTRODUCTION**

At the end of 2007 the Council and the European Parliament agreed the text of the Rome 1 Regulation and it is expected that it will be formally adopted later in 2008 and come into force a further 18 months after that.

The Regulation will change the position on the law applicable to contractual obligations. During its development changes were proposed which, if adopted, could have had significant implications for cross-border financial services and markets business. ESME raised a number of concerns about a provision in the draft which would have affected contracts with consumers. This note records the concerns raised by ESME, the final position in each case and notes any unresolved issues.

**1. DEALING WITH CONSUMERS-MANDATORY APPLICABLE LAW**

**(a) Proposal**

It was proposed to change the approach to consumer contracts to that contained in Article 5 of the Rome Convention. The Rome Convention recognises the validity of freedom of choice of the governing law of a contract, save that in the case of certain consumer contracts such a choice cannot deprive the consumer of the protection afforded him by the mandatory laws of his place of habitual residence. It was proposed to abolish the freedom of choice for consumers so that the whole of the consumer's home law would apply to contracts with him. There was to be no ability to contract out of this position. This would have meant that the following issues (amongst others) would be governed by the consumer's home law:

- ⇒ consent and material validity;
- ⇒ formal validity;
- ⇒ interpretation;
- ⇒ performance;
- ⇒ consequences of breach, including assessment of damages;
- ⇒ consequences of nullity of the contract.

Some of the implications that flowed from this proposed change are dealt with separately in the paragraphs below.

ESME raised concerns about the potential impact that such a change could have on all providers of cross border financial services, (particularly, although not limited to, EEA companies that use distance means of communication (e.g. the Internet) to provide financial services). The legal risk and regulatory costs for such companies would have been considerable with potential cost implications for consumers.

**(b) Final position**

The final version of the Regulation represents a reversal of the draft position and, broadly, a return to the existing position. Article 6 on consumer contracts allows the parties to choose the law applicable to a contract but provides that such a choice may not deprive the consumer of the protection afforded to him by such provisions that cannot be derogated from by contract by virtue of the law which, in the absence of choice, would have been applicable. For the reason given below, the position has therefore not substantively changed in the way originally proposed, although we note below that the wording of the Regulation differs from that in the Rome Convention and may therefore result in a slight change of scope.

Article 5(2) of the Rome Convention provides that a choice of law cannot deprive a consumer of the protection afforded to him by the mandatory rules of the law of the country in which he had his habitual residence if:

- in that country there had been a specific invitation addressed to him or he had taken in that country all steps necessary on his part to conclude the contract; or
- the other party or his agent received the consumer's order in that country; or
- the consumer travelled from the country for the sale of goods but the journey was arranged by the seller for the purpose of inducing the consumer to buy.

The concept of "mandatory rules" is materially the same as that in the Regulation of "provisions that cannot be derogated from by contract by virtue of applicable law" (see Article 3(3) of the Convention). Therefore, both the existing and the new legislation preserve the application of certain mandatory rules, whilst permitting a general choice of law.

The principal distinction between the old and the new legislation is therefore in relation to the circumstances in which the protection of the *mandatory rules* for consumers will apply. It is arguable that Article 6(1) of the Regulation applies the mandatory rules to a wider range of consumer contracts than might be caught under the conditions in Article 5(2) of the Rome Convention summarised above. This is because Article 6 of the Regulation will apply to contracts where the professional:

- either pursues his activities in the country where the consumer has his habitual

residence; or

- by any means, directs such activities to that country or to several countries including that country.

This is potentially wider and has particular relevance to firms that do business via websites or otherwise over the internet.

The conclusion is that the principal concern that the whole of the consumer's home law would apply to the contract has been relieved and the position is essentially the same as it is under current law, subject to the fact that the new principles might apply to a wider range of consumer contracts due to the use of the internet and the difference between the conditions in Article 5(2) of the Rome Convention and Article 6(1) of the Regulation noted above.

## **2. LOCATION OF CONSUMERS**

ESME noted that the proposals did not appear to be limited to consumers habitually resident in the EEA. As a result, if the proposal described in paragraph 1(a) above had been adopted, an EEA firm which had customers around the world would have found that its contracts were entirely governed by multiple overseas legal systems, many of which would have had no resemblance to the legal system which governed the firm and which may indeed have been undeveloped. For example large private banks are likely to have customers in Asia, Africa, the Middle East, various U.S. states and Russia as well as Europe. The legal uncertainty resulting from the proposal would have been a strong disincentive to base a global financial services operation in Europe.

It remains the case that there is no limit on the effect of Article 6 to consumers habitually resident in the EEA. This appears also to have been the case under the Rome Convention. However the concern raised in this point is now no greater than the concern today, due to the important retention of freedom to choose the governing law.

## **3. HABITUAL RESIDENCE OF CONSUMERS**

As can be seen from the above, a consumer's habitual place of residence is key to determining which "mandatory" rules apply to a contract where the parties have agreed a different governing law. ESME raised concerns that there is no common understanding as to (i) where the "habitual residence" of a consumer is (it may even depend upon subjective matters of intention) or (ii) at what time (e.g. contract formation) it needs to be determined or (iii) as to the position if the habitual residence of the consumer changes during the term of the contract. These issues arose under the Rome Convention but were not clarified by the Regulation which means that in some cases there is the risk of legal uncertainty.

Thus the habitual residence of a consumer is not defined with any specificity. Although Recital 39 notes that, for the sake of certainty as to the law, there should be a clear definition

of habitual residence, it only singles out the habitual residence of bodies corporate as being of particular interest. The only provision which address in part the issues raised is Article 19(3) which states that when determining the habitual residence the relevant point of time shall be the time of the conclusion of the contract.

#### **4. HOME STATE/HOST STATE**

The proposal to remove the ability of the consumer to choose the applicable law would have led to a fundamental mismatch of approach between the Regulation and those recent financial services directives that adopt a “home state”/”state of origin” approach to the regulation of financial services in the interests of consumers, including Article 31 MiFID (freedom to provide investment services under COB rules of home state of investment firm or credit institution), the DMD and the E-Commerce Directive. ESME noted that this would cause considerable legal uncertainty for financial services providers where a matter required by one of these Directives is to be determined under the laws of the home state/state of origin; but the same matter is under the Rome I Regulation to be determined by the law of the habitual residence of the consumer.

These concerns are no longer relevant and/or are not significantly greater than they were under the Rome Convention due to the acceptance that consumers may choose a governing law. That is not to say that there are no issues, but that the position is not made materially worse by the new Regulation.

#### **5. SETTLEMENT FINALITY CONCERNS**

If the proposal had been adopted it would have led to a fundamental mismatch with the principle of party autonomy enshrined in the definition of “system” in Article 2(a) of the Settlement Finality Directive. This could have undermined the designation under the SFD of those securities settlement systems that have consumer-participants (e.g. the UK and Irish securities settlement systems). These systems have contracts with consumer-participants that give effect to the system’s common rules and standardised arrangements for the execution of transfer orders sent into the system by or on behalf of consumer-participants in relation to securities held in the name of the consumer-participants in the system. In order to be designated under the SFD, and to receive the systemic protections provided by it against the insolvency of any participant, the system must be governed by a single EEA law and be designated by the competent authority of that EEA state.

The proposal would have created uncertainty for systems with multiple consumer-participants habitually resident in EEA states outside the jurisdiction of the system, as to whether such a system had such a single governing law. This would, at the very least, have undermined market confidence in such systems and the SFD protection purportedly provided to them; and would have been a rich source of attack for a liquidator of any participant (including a financial institution or other corporate participant) in the system to seek to unwind or reverse the finality of settlement in the system.

This concern also appears to be alleviated by the recognition of the ability of parties to choose the law applicable to a contract. The Settlement Finality Directive defines a system in Article 2(a) as being a formal arrangement "governed by the law of a Member State *chosen by the participants*". Now that the Regulation recognises that participants may choose the law of a Member State that is applicable to their contract the position is no different to that which applies under the Rome Convention and does not prevent the system being one that is governed by a law that has been "chosen" by the participants. In addition, Recital 31, which provides that nothing in the Regulation is to prejudice the operation of a formal arrangement designated as a system under the Settlement Finality Directive is extremely helpful in clarifying the intended position.

## 6. MTFs

ESME thought it was important that the proposal did not affect contracts concluded on an exchange or MTF. The view was that MiFID will encourage competition between such trading platforms and, as part of that competition, ESME would expect an explosion in the provision of central counterparty (CCP) services to support the clearing and settlement of trades executed on them. Under such services, it is possible to get the following contractual chain under an agency trade:

consumer 1  $\Rightarrow$  General Clearing Member (GCM1)  $\Rightarrow$  CCP  $\Rightarrow$  GCM2  $\Rightarrow$  consumer 2

The integrity and stability of this contractual chain may be dependent upon:

- (a) the contracts between consumer 1-GCM1 and GCM1-CCP; and
- (b) the contracts between CCP-GCM2 and GCM2- consumer 2,

being matching back-to-back contracts in respect of the trade. An element in the management of the legal risks for the CCP (and its clearing members) created by the interposition of the CCP is that it may assist if all of the matching contracts are governed by the same single law. The proposal would have meant that CCPs were not free to achieve this result. Where the arrangements for an exchange or MTF seek to achieve this result (thus dealing with the risk that different laws might produce different results in relation e.g. to performance or the assessment of damages), it was important that these arrangements were not impeded because it could have had adverse systemic consequences for the default rules of the exchange/MTF or the CCP.

This concern is no longer relevant as the consumer contract provision does not apply to contracts concluded within MTFs (including exchanges) by virtue of Article 6(4)(e). This is arguably an improvement on the position under the Rome Convention, where such contracts could be affected by the application of the mandatory rules.