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INVESTMENT SERVICES FROM THE PERSPECTIVE OF CONTRACT LAW

Theses of Phd Dissertation

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I. SUMMARRY OF RESEARCH TASK, RESEARCH OBJECTIVES

In Hungary, the first Act involving the regulation of investment services was enacted in line with the process of the transition period from the centrally planned economy to the market economy, sixteen years ago. Then the regulations of investment services were made in harmony with the developmental stages of the Hungarian capital market.

The regulation of investment services –since they were enacted – is systematically renewed every 5-6 years, which has simultaneously maintained this issue up-to-date. The fact that law makers regularly amend the provisions of investment services within such short period of time, often basically changing them, can be attributed not only to the constant changes of the capital market and the requirements of legal harmonization, but also to the characteristic features of providing investment services as a special kind of service, which is a fairly complex, elaborate and difficult field.

Transactions in the capital market play an essential role in the operation of the economy in each country and the capital flow, that is, in maintaining the "blood circulation" of the economy. Despite their major importance, investment services make up an unexplored area in legal literature, justifying the choice of this topic, that is the institution of investment services, as a research task.

The research aims at several goals.

The basic and primary goal I set was - first in Hungarian legal literature – a detailed examination of investment services featuring this specific field as an individual contract type. The analysis is done according to the classical pattern, that is, by exploring the characteristic features of the subjects, objects and content of legal relationships simultaneously presenting the progress in the legal regulation of investment services in the period from the Act of Securities to the provision of law in effect to date.

Another major goal of the research was to explore the relationship between the contracts of providing investment services and contract law. The codification of the Civil Code made it a timely issue to identify connections between commercial law deals in the capital market and the classical contract types in the Civil Code. The modernization of contract law defined in

the Civil Code was based on commercial law by prioritising the business-like character, which provided an appropriate basis for the comparative analysis of investment services and three traditional contract types: agency contracts, consignment contracts and that of bailment contracts.

The third goal of this thesis is to define the position of investment service contracts – as an individual contract type – in the system of contracts within the Hungarian legal system. There are three aspects of classification distinguished in the thesis: defining investment services related to civil law contracts and commercial law contracts, followed by placing investment service contracts in the system of capital market transactions, finally comparing investment service contracts with the category of typical contracts regulated in the Civil Code.

II. RESEARCH METHODOLOGY

This thesis extends to the examination of investment services from the perspective of contract law.

The current thesis sums up the results of *several years' research*. The beginning of my research and my first paper published in this topic coincides with the enactment of the first Act of investment services in the Hungarian legal system.

The primary problem of the research is represented by the extreme difficulty, the novelty of the topic together with the heterogeneous and diverse character of investment services.

My research has highlighted the contradictions between the theoretical *deficiency* of investment services and their major importance, frequency and great significance in capital market transactions. Investment services together with other capital market transactions and the material rule of the investment sector are difficult to apprehend and not popular with Hungarian law makers. In our country, there is relatively little legal literature dealing with the phenomena of the capital market. To the best of my knowledge, there is nobody else researching investment services, that is why I can only cite my own papers published previously.

The scope of investment services is not homogeneous in the smallest measure possible. Law makers classify dissimilar and diverse activities being completely different in character into the same category and qualify them as investment services and supplementary investment services. According to the law in effect there are eight investment services and eight supplementary investment services defined. The scope of financial instruments constituting the indirect object of the legal relationship regulating investment services is also large and extended. There are as many as eleven financial instruments enabling the provision of investment services together with supplementary investment services. Therefore, it was necessary to apply a *manifold restriction method*. Namely, in this colourful palette, the focus was put on solely on negotiable securities, that is, taking, transferring and executing securities orders. According to my judgement, the statements and conclusions I have drawn are of

general value, and they are also adequate when transactions include other types of financial instruments, other investment services or supplementary investment services (e.g.: investment counselling, placement or portfolio management).

In the thesis, the examination of investment services proceeds from the *specific* to the *general*.

First, the dissertation provides a detailed description and analysis of the institution of investment services. The rules of contract concerning investment services are examined in line with the structure of the Civil Code, that is, they are grouped around the subject, object and content of legal relationships together with the enactment and termination of legal relationships. While analysing substantial characteristics, I simultaneously attempt to compare the regulation of investment services from several perspectives. Consequently, the research method can be termed as analytical and comparative in character.

a) The regulation of investment services can be analysed from a historical point of view. Accordingly, one aspect of comparison is represented by the temporal level, in other words, I aim at presenting the progress of the regulation of investment services by comparing the regulation of legal sources created in the given topic. I demonstrate how and to what extent the regulation of investment services have developed, changed and extended from 1990[1] up to now. Three legal sources regulating investment services – Act of Securities 1966, Act of Capital Market 2001 and Act of Investment Services 2007 are projected on each other with regard to the major questions of the regulation of investment services.

b) In the next stage, the thesis provides comparison on another level, from the perspective of contract law. One chapter is devoted to the comparison of investment services with the three classical civil contract types: agency contracts, consignment contracts and that of bailment contracts each. In the scope of this, it is explored what characteristic features of these contracts are identical and similar or completely different from each other. While mapping the connections between investment services and contract law, I attempt to define the characteristics of agency contracts, consignment contracts and bailment contracts present in providing investment services, since to my mind, the obligations of investment services feature a mixture of the traits of these three contract types.

In addition to this, it is also pointed out that the contract of investment services is not identical with the total of agency contracts, consignment contracts and bailment contracts, since there are numerous characteristic features defined by law makers which apply only to the provision of investment services, while there are traits which - though present in the traditional civil law contracts mentioned above – are different in force in investment services.

Within the scope of the examination of contract law, it is not only *the current regulation in effect* that is presented, but also the *legal regulation in the future*, that is, the products of the codifying process are also included. The basis of analysing classical civil law contracts is provided by the Civil Code, however, I also monitored the different products of the codifying process of the Civil Code while writing my thesis. At the initial stage of preparing my thesis I got acquainted with the new concept of the Civil Code by Lajos Vékás and the experts' opinion related to it. This was followed by the Bill number T/5949 proposed by Gábor Gadó and Act number XX of 2009 which had been made, but did not come into force. The final form of my thesis considers the text of the Recommendations by the Codification Committee on the new Civil Code – hallmarked by the name of Vékás Lajos – and extends to the expected new rules in the regulation of agency, consignment and bailment contracts.[1]

c) Acts regulating the provision of investment services do not exclusively come under private law, but represent a complex legal field. Capital market movements and transactions are acts strongly controlled by the state, consequently, their legal regulation affects both private and public law (the latter involving administration, financial and criminal law alike). The Hungarian Financial Supervisory Authority–PSZÁF are authorized with a lot of power concerning the provision of investment services. Therefore, when analysing the specific features of their regulation, I also look at the rules of supervisory power within financial law.

d) The legal regulation of providing investment services is largely subjected to the EU directives.

Hungarian law makers already considered the respective directives and our obligations of legal harmonization to a great extent when the first rules of investment services were

[1]The very beginning of the regulation of investment services is already contained in Act IV/1990 for the first time in the Hungarian legal system, as transaction later qualified as investment service is defined in the rules of stock broking stipulated in Articles 35-37 of this Act, however, the category of investment services as such was then unknown in the Hungarian system.

defined. Though the Hungarian Securities Act and Capital Market Act had been in harmony with the whole European Union, the regulation of investment deals seemed to be rather heterogeneous. In this field, further development was hindered by the fact that the minimum harmonization requirements allowed the member states to apply different regulations. "The European Union recognized that globalization and technological revolution together with the sharpening competition necessitated an accelerated liberalization and market unification."[2] Therefore, the European Union developed a unified regulation, which was based not only on the rules of one member state, but the legal rules of several member states were fused. This directive of unification 39/2004/EU (MiFID) had to be implemented by each member state. The unified market in this case also implies that investment ventures authorized by their own national supervisory authorities can provide their investment services observing identical regulations in each member state. Consequently, there are no more considerable differences between the member states in their legal rules of this field, as MiFID directive has eliminated the previous differences. Therefore, my thesis does not target at examining either the respective legal regulations of other EU states or the implementation of this directive by the individual member states. My thesis gives a comparison of the text in the European directive with the Hungarian law implementing it, but it does not touch upon any other issues in European law. So I focus on the topic indicated in the title of my thesis, that is, investment services from the perspective of contract law.

Part four of the dissertation applies analytical and comparative methods to systemize the specific features, different and similar traits of private and collective investment schemes by comparing investment services and investment funds.

The final structural unit is devoted to classifying and typifying contracts. In order to achieve this goal, the historical approach is applied. The different views are examined in three blocks of time. First the most significant theories concerning mixed and atypical contracts from the first half of the 20th century are quoted. They are followed by the thoughts and ideas devised in the 60's, 70's and 80's. Finally, the views published in this subject matter by my contemporaries for the last two decades ranging from the change of the regime to date are presented. Then my own system is set up based on all this.[2]

[2] [2]Attila Marján: The Economy of the European Union – All that you have to know about the economic and financial policy of the EU, HVG, Budapest 2006. 438. p.

III. SUMMARY OF SCIENTIFIC RESULTS AND THE PERSPECTIVES OF THEIR FURTHER UTILIZATION

1. The examination of a legal field unexplored in legal literature

The primary and general result of my thesis is that it examines an institution being considerable both from economic and legal perspectives, while representing a *significant, timely and unexplored* field.

Investment services – due to their economic role, their function in the capital flow and the value and size of this kind of transactions – classify as a basic institution of the capital market.

The legal framework of providing investment services and the periodically modernized legal regulation continuously make this special field of securities law a current issue.

Despite its importance and topicality, this theme has not been dealt with for the last sixteen years. Law makers have paid little attention to this topic. As for the investment services from the perspective of contract law, I am the only one researching it. Consequently, my thesis in this respect, is a *stop-gap and unprecedented.*

2. The comparative analysis of the three "carrier laws" regulating investment services

The legal rules of investment services subjected to a three-level analysis are compared with the regulations in the three laws allowing a description of the changes and development in regulation till the enactment of the current Act in force.

3. The contract of investment services as a new, individual type of contract

For the first time in Hungarian legal literature, the legal relationship regulating the provision of investment services is modelled as an individual type of contract. According to the structural division of contractual obligation, the legal regulations of investment services are distinguished and grouped around the subjects, objects and content of the legal relationship.

4. The exploration of connections between investment service contracts and contractual obligations and the definition of the concept of investment services

I have concluded that the legal relationship regulating investment services and supplementary investment services feature a mixture of traits of basically three traditional civil law contracts. Accordingly, an investment service contract is a kind of skeleton agency contract which performs investment services through accomplishing the legal relationships of consignment and bailment featuring specific content.

In contracts of investment services, the features of the obligation of care and result, together with the traits of agency, consignment and bailment contracts and the specific features of the law on investment ventures supplemented with rights and duties constitute a specific, new type of contract that can be named as contract of investment services due to its obvious goal and direction.

5. Comparative analysis and identification of distinguishing features in individual and collective investment schemes

In the capital market, both individual and collective investment schemes play an important role.

The contractual obligation of investment services provides a legal framework to accomplish individual investment schemes, whereas investment funds represent a "collective investment scheme"[3] in the sense that the portfolio of the investment fund is made up of investment instruments purchased with the money of several investors and it is explicitly qualified as such by the law.

There is also a difference between the two investment forms regarding the *grade of transaction risk.*

Each form of investment is hazardous – individual investment schemes always involve a higher grade of risk, while collective investment schemes feature less risk as risk is shared on several levels. It is partly shared between the investors owning investment units in the fund. The risk is further shared between the instruments included in the portfolio of the given investment fund.

There is a further difference regarding the *subjects* as investment services can be provided by investment ventures, while investment funds can be set up and operated by management companies, which manage the funds together with other subjects (trading company, bailment manager, real estate appraiser)

The right of issuing securities also differs. It is the management company which has the right to issue securities allowing its trading in investment units. Investment ventures, as a main rule, do not have a right of issuing securities. A definite group of investment ventures are authorized to issue secondary securities (subscription guarantee, securities bailment management, securities account).[3]

There is a difference in the *rules of duty of disclosure*. The content, the terms and formal requirements of the duty of disclosure are greatly different from each other in investment funds and services. Investment ventures are obliged to disclose information to clients, whereas management companies are obliged to provide regular and special information about the public issue of investment units from the moment of their appearance till the management company has any obligation concerning the securities. So it can be stated

[3] Point 43 Article 3 in Act on Managing Companies and Collective Investment Schemes.

that the duty of disclosure applying to investment ventures is client-oriented, whereas the duty of disclosure applying to management companies is securities-oriented.

There are differences in *the termination of the legal relationship*. The contract of investment services can be terminated in all possible ways applied in general, that is, by bilateral agreement and unilaterally exercising the right of notice alike.

The rights of investors in investment funds are manifested in securities, therefore, it is easier for the investor "to get rid of" this obligation as the sale, transfer or redemption of investment units can be carried out more easily than the termination of investment service contracts. Apart from this, it is the termination of the investment fund (accounts are settled with investors due to the expiration of term), or its termination either by the decision of the management company or due to the withdrawal of the permit by The Hungarian Financial Supervisory Authority–PSZÁF, or the termination of the management company and the investment company due to a lack of a legal successor that can entail the termination of the legal relationship.

6. Placing investment service contracts in the system of contracts according to the author's own classification aspects

According to the classification worked out in this dissertation, investment service contracts are first defined as *commercial contracts* related to civil law and commercial law contracts, considering that at least one of their subjects is an economic organization performing businesslike economic activities and having the necessary expertise to manage transactions of a similar kind. In the scope of investment service contracts, at least one party, that is, the investment venture must meet these criteria.

In the second stage, investment service contracts are placed in the system of capital market transactions. Capital markets evoke different transactions enabling capital movement, capital flow and capital intermediation. When classifying these transactions, the group of *investment transaction* is defined as the broadest category, incorporating all kinds of contracts – civil and commercial alike – which aim at investments.

They are subdivided into *investment contracts*, which are explicitly concluded in capital and securities market.

They include primary market transactions, that is, the contract between the issuer of securities and the first customer of the given securities together with the transactions implemented in the secondary markets, including *investment service contracts*, transactions concerning the stock exchange and investment funds.

In the third stage, the contract of investment services related to a typical contract as defined in the Civil Code is regarded as *innominate and atypical mixed contract* that can be further divided into the category of *multi-type contracts.*

7. Problem statement

7.1. The issue and problems of regulating the concept of investor

The legal relationship regarding the provision of investment services is established between the investment venture and the client. The status of one subject of the legal relationship, namely that of the client has changed in that the previous legal regulations clearly qualified the client concluding a contract with an investment venture as investor.

The concept of investor has changed in each act.

According to the Securities Act, an investor is a person who takes risks by exposing his own money or other assets or somebody else's money or other assets partly or wholly to the effects of the securities market or the stock exchange as defined in the contract drawn with the issuer, investment service provider or other investors.

According to the Capital Market Act, an investor is a person who takes risks by exposing his own money or other assets or somebody else's money or other assets partly or wholly to the effects of the capital market or the stock exchange as defined in the contract drawn with an investment service provider, a management company or some other investor.

The concept of investor is currently defined both by the Capital Market Act and the Investment Funds Act.

In 2007, the client making an investment service transaction with an investment venture was omitted from the concept of investor as defined in the Capital Market Act. Now a person is only defined as investor by the Capital Market Act in force if he takes risks by exposing his own money or other assets or somebody else's money or other assets partly or wholly to the effects of the capital market, regulated market or the stock exchange as defined in the contract drawn with a management company or some other investor.

The law regulating investment funds considers only the owners of investment units or other collective investment securities as investors.

The concept of investor in the current law in force features manifold contradictions with regard to defining the status of investor.

The MiFID directive considers all kinds of clients as investors. Unlike the Act on Investment Services, which does not even give a definition of investor. The Capital Market Act and the Act on Managing companies and Collective Investment Schemes do not include clients contracting to an investment venture. These two Acts give a different definition of investor anyway.

Defining an investor is a problem with regard to retail clients. Since professional clients and eligible counterparties qualify as institutional investors.

At the same time, however, private clients are qualified by the Act on Investment Services as investors with regard to the application of investor protection rules since all these rules apply to them. The party doing business with an investment venture is regarded as investor according to the economic content as well, since his money and other assets are exposed to the effects of the capital market, in other words, he takes risks.

I have also recognized a problem in defining the category of professional client and eligible counterparty. The two categories – that is, the groups of clients qualifying as professional or eligible – are almost identical and the borderline between them is narrow and relative. It has not been clarified when a person can be qualified as eligible counterparty or professional client, especially because an eligible counterparty himself can request to be qualified as professional client. This image is made even more varied by the fact that according to the Capital Market Act, a person qualifying as professional client is regarded as institutional investor, though the category of professional client is somewhat broader.

I consider that this problem could be adequately solved with a clear definition of retail client, eliminating contradictions and by restoring the status of investor. Furthermore, in my opinion, it would be practicable to harmonize and unify the concept of investor and categories included in the three Acts bearing great significance in the regulation of investment service contracts.

7.2. The problem of regulating the duty of disclosure

The regulation of the duty of disclosure has been a considerable issue of the European directive providing the basis for the respective Hungarian law in force. All the directives governing this issue have been completely implemented resulting in a coherent system concerning the duty of disclosure.

Law makers attach the duty of disclosure to each stage of the contractual relationship. Investment ventures are obliged to disclose and obtain information comprehensively even prior to concluding a contract and in addition to this, there are strict regulations obliging them to provide information to the client during and after the performance of the legal relationship.

The duty of disclosure differs not only according to the stages of the contract, but also according to the categories of clients. With retail clients, the duty of disclosure is fully to be observed, whereas the scope of the duty of disclosure is much narrower with professional clients and eligible counterparties as they generally have the same type and amount of information about the phenomena and movements of the capital market.

Law makers observe the requirements of the duty of disclosure obliging investment ventures as stipulated in the European directive, however, I personally think the development of national regulations seems to be overregulated. The scope of the duty of disclosure is so extended and detailed that when it is totally observed, it hinders and delays the performance of transactions or it gains a completely formal character, which challenges the disclosure to fulfil its function of protecting the investor. In conclusion, I find it necessary to reconsider the regulations concerning the duty of disclosure and simplify them in order to make them really feasible and increase their efficiency.

IV. PUBLICATIONS BY THE AUTHOR IN THE GIVEN FIELD OF RESEARCH

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