REGULATING BUSINESS IN CYBERSPACE

CLIVE BARNARD AND **MARK TURNER** OF HERBERT SMITH LOOK AT SOME OF THE NEW REGULATORY INITIATIVES IN THE UK AND EUROPEAN UNION REGARDING ONLINE FINANCIAL SERVICES.

The attractiveness of selling financial services online is undeniable. The intangible nature of financial products sits well with the versatile new medium of the internet. The ability for businesses to access a broader base of customers across numerous jurisdictions is appealing. The internet offers financial service providers numerous advantages over traditional business methods including reduced costs, cross-selling, access to global markets, increased competition – the list goes on and on.

The commercial advantages presented by the internet are, however, clouded by legal and regulatory uncertainty. The internet makes geographical boundaries, the cornerstone of the current regulatory approach, non-existent. This presents financial services companies, regulators and legislators with fundamental problems in determining the governing law for financial services, how to regulate and how to enforce regulation.

THE INTERNATIONAL CHARACTER OF THE INTERNET. The absence of geographical barriers means that traditional methods of ensuring compliance are no longer sufficient. A service provider based thousands of miles away from its customer may be reluctant to recognise the authority of the local regulator. The regulator is obliged, usually under a statutory regime, to protect consumers and consumer confidence and maintain stability and integrity of the financial markets by ensuring proper disclosure of information, competency of suppliers, and ensuring fraud is kept in check. These obligations become all the more fraught in the face of growing public concern over the lack of control of activities on the internet. The balance between not stifling legitimate commercial development and protecting investors and ensuring proportionality in regulation is difficult to achieve.

Regulators such as the Financial Services Authority (FSA) in the UK and the Securities Exchange Commission (SEC) in the US have agreed to adopt a 'directed at' or 'targeted at' approach to financial services regulation. This approach has found favour in many international bodies: it is recommended by the International Organisation of Securities Commissions (OSC), suggested by the International Association of Insurance Supervisors (IAIS) and enshrined in the recent EC regulation on Jurisdiction and the Recognition and Enforcement of Judgments in Civil and Commercial Matters (44/2001/EC). This sets out the circumstances in which an EC member State court has jurisdiction over financial services. A financial services provider which directs its services at, for example, citizens in the UK, will come within the remit of the FSA and will need to comply with UK laws and regulations.

THE APPROACH OF THE FSA. A recent discussion paper from the FSA, *The FSA's approach to the regulation of e-commerce*, published in June 2001, identifies the e-commerce-related risks that may prevent the FSA from it achieving its statutory objectives of: maintaining market confidence; promoting public awareness; protecting consumers; and reducing financial crime (see sections three to six of the new Financial Services and Markets Act 2000), while maintaining efficient, orderly financial markets, and ensuring that retail consumers get a fair deal.

The FSA's view is that the internet presents numerous risks due to the enhanced opportunities for financial crime, the catastrophic effects of breaches of IT security, the difficulties of regulating businesses operating in other jurisdictions, and the lack of consumer understanding. The regulator has, however, expressed its wish to develop a 'sensible approach' to the global nature of the internet and is seeking to reduce the legal risks for firms operating through this medium. This risk-based approach was initially set out in the FSA's January 2000 document *A new regulator for the new millennium*, and is outlined in Carol Sergeant's article on page 34.

The FSA considers the following areas/principles to be key in the future management of e-commerce:

- the role of senior management in meeting the challenges of e-commerce: it is the responsibility of senior management to 'grasp the nettle' in managing IT systems;
- regulation should facilitate innovation by avoiding unnecessary barriers to launching new financial products and services;
- regulation must have due regard to the international character of financial services and markets and the desirability of maintaining the competitive position of the UK;
- any adverse effects of regulatory decisions on competition need to be kept to a minimum; and
- proportionality in regulation.

The FSA cites the use of financial domain names as a way for consumers to easily identify whether or not a firm is authorised, before buying financial services from them. The Internet Corporation for Assigned Names and Numbers (ICANN), the agency that controls domains, has indicated that it is willing to authorise a new top-level domain for authorised financial services firms. However, the FSA concluded that the difficulties and costs associated with operating a top-level domain name such as **www.firm.uk.fin** were not currently justified by the potential benefits but acknowledged that this cost benefit analysis may change over time.

One particular concern of the FSA in relation to financial crime is the trust being placed in digital signatures. The FSA is concerned that any organisation is free to establish itself as a trust service provider and warrant the identity of a party to a transaction by granting digital certificates to support electronic signatures. The recent Electronic Signatures Directive (99/93/EC) precludes any licensing or authorising regime. The reliability of such digital certificates will, therefore, depend on the reliability of the certifying party.

The FSA is concerned that businesses and consumers will need to be wise to this and decide for themselves the reliance they are willing to place on the issuers of digital certificates. The paper consults on whether there should be specific applicable standards before digital certificates, supporting a digital signature, can be used for the purpose of entering into a financial relationship.

THE NEW UK STATUTORY REGIME. The new Financial Services and Markets Act 2000 (FiSMA) will replace the Financial Services Act 1986, Banking Act 1987, Insurance Companies Act 1982, and regulatory parts of The Friendly Societies Act 1992 and The Building Societies Act 1986. The FiSMA seeks to create a single regime, bringing together the disparate laws and regulations in the area of financial services and create one comprehensive regulator to replace the previous nine regulators in the industry. The FSA will control all regulated activities and will make it a criminal offence to carry on such activities without authorisation or exemption. The main provisions will not come into effect until 30 November 2001.

Under the FiSMA, non-European Economic Area authorised firms will have to indicate on their website that: the communication is not directed at UK persons; the communication must not be acted on by persons in the UK; ensure that any communication in which a financial promotion is contained is not referred to, or made accessible from any communication directed at persons in the UK; and have proper systems in place to prevent UK persons from doing investment business with them. If firms outside the European Economic Area (EEA) comply with these four requirements they will be able to benefit from a legal safe harbour and avoid compliance with UK financial promotion requirements. Essentially the principles behind the old regime under the 1986 Financial Services Act will remain intact, although there will be an extension of powers for the new regulator. With this new statutory standing will also come the real enhanced authority that seems inevitable from the creation of one financial services regulator instead of the nine previous regulators.

EU INITIATIVES. The European Union is taking a keen interest in the development of e-business generally and online financial services in particular and has enacted several directives affecting online financial services. In addition to those already mentioned, the Electronic Commerce Directive (2000/31/EC) is an example of legislation for the internet. The broad thrust of this Directive enables businesses generally, but not financial services providers, to operate across the EEA subject to the laws and regulations of the Member State from where the service is provided. This is known as the 'country of origin' approach whereby national measures cannot restrict the free movement of information society services. This approach relies heavily on mutual confidence and co-operation between Member States. There are, however, a number of derogations from this principle, including for financial services. In addition, it applies only to services provided through the internet and email and only to the pre-contractual phase. The Commission would like to remove these derogations and extend the principle to all non-face-to-face media, develop redress mechanisms and, in time, potentially harmonise financial services contracts.

The EC has created its own deadline of 2005 to establish an integrated European market in financial services. In the February 2001 *Communication from the Commission to the Council and the European Parliament on E-Commerce and Financial Services*, the Commission set out its initiative in detail.

GLOBAL ANOMALIES. The ideal of harmonisation of laws and regulations in the rest of the world will founder due to competing national interests. Differing standards of regulation exist in other parts of the world, often due to the fact that laws and regulations are drawn up to meet specific national/market concerns. For example, custodial services and fund management are usually deemed to take place in the State where the service provider is based, while investment advice and loan provision are usually deemed to take place in the State in which the service recipient is based. In some States, for example, providing advice need not necessarily result in a requirement for authorisation, while in the UK this, as a general rule, amounts to a regulated activity.

The levels of supervision and disclosure vary from State to State, making it difficult for the untrained observer to make a comparison between products. The level of consumer protection may also differ widely. All of these anomalies make it difficult for consumers to make an informed choice about international offerings of financial products and services. The hindrances to creating a well functioning and robust global financial services market seem insurmountable.

THE FUTURE, HARMONISATION AND CO-OPERATION? The future for the provision of online financial services for UK providers is likely to remain focused in the EU, where harmonisation and co-operation will progress more quickly. There may also be a degree of harmonisation and co-operation with other like-minded jurisdictions, such as the US. Further work clearly needs to be carried out to develop consistent regional standards and global standards, which are sufficiently robust to maintain orderly, stable markets with sufficient investor protection.

While there has been progress towards establishing a solid regulatory framework in which financial products can be bought and sold in cyberspace, there is still much work to be done. There must be a consistent approach to online transactions on a global scale and a transparent and consistent regulatory framework for the benefits of the internet to be achieved. The challenge for all governments and regulators is how to strike the correct balance between sound and guiding regulation and the freedom to innovate while keeping pace with the rapid evolution of the use of the internet.

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