
ARTICLE

MANAGING REGULATORY JURISDICTION: CROSS-BORDER ONLINE FINANCIAL SERVICES AND THE EUROPEAN UNION SINGLE MARKET FOR INFORMATION SOCIETY SERVICES

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I. INTRODUCTION

In theory, there is no limit on the circumstances in which a national government might claim to apply its laws and regulations to activities which originate in a different jurisdiction, although effective enforcement of those laws against a foreign enterprise is a different matter.¹ In practice, however, governments attempt to limit the extraterritorial effect of their laws by applying the principle of comity² to reduce the risk of legislative “arms races.”³ In essence, comity requires that a state should not claim to apply its legislation to persons within another state unless it is reasonable to do so, which normally means that legislation should be undertaken by the state which has the greater interest in so doing.⁴

This principle of comity is challenged in complex ways by online activities.⁵ Clearly, one or more country’s laws and regulations must be applicable to at least some parts of each online transaction. All the actors involved have a physical-world

1. See, e.g., CANADA CUSTOMS AND REVENUE AGENCY, ELECTRONIC COMMERCE AND CANADA’S TAX ADMINISTRATION, A REPORT TO THE MINISTER OF NATIONAL REVENUE FROM THE MINISTER’S ADVISORY COMMITTEE ON ELECTRONIC COMMERCE § 4.2.2 (1998) [hereinafter CANADA’S TAX ADMINISTRATION] (recognising the difficulty of enforcing tax laws on economic activity that originates outside of Canada), available at <http://www.cra-adrc.gc.ca/tax/business/ecom/ecom0-e.html> (last visited Oct. 3, 2001).

2. The U.S. Supreme Court has defined comity as “the recognition which one nation allows within its territory to the legislative, executive, or judicial acts of another nation, having due regard both to international duty and convenience, and to the rights of its own citizens or of other persons who are under the protection of its laws.” *Hilton v. Guyot*, 159 U.S. 113, 163–64 (1895).

3. See generally Harold G. Maier, *Extraterritorial Jurisdiction at a Crossroads: An Intersection Between Public and Private International Law*, 76 AM. J. INT’L L. 280, 282–83 (1982) (describing the practical need for comity to facilitate international, economic, and social discourse).

4. See, e.g., RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 403(1), (3) (1987) (amended 2001).

5. See, e.g., Council Directive 2000/31/EC, 2000 O.J. (L 178) 1 [hereinafter Directive on Electronic Commerce] (describing comity-type challenges faced by “information society services” in the context of the European Community); CANADA’S TAX ADMINISTRATION, *supra* note 1, § 4.2.2–4.2.2.5 (analysing the complexities of the impact of electronic commerce on inter-jurisdictional tax issues, especially corporate residency, permanent establishment, and international allocations).

existence, and are located in one or more legal jurisdictions. Similarly, each piece of computing and communications equipment through which the transaction takes place is located in a legal jurisdiction, even though it may be difficult to identify precisely which equipment was in fact used for any particular transaction. However, when online transactions are undertaken via a global, open network—such as the Internet—the number of countries whose regulations might apply to some part of the transaction increases dramatically.⁶ In some instances, a transaction whose physical-world analogue would have been restricted to only one or two jurisdictions may potentially be subject to every jurisdiction—this is particularly clear in the case of advertising via a Web site.⁷

When legislatures are considering new laws, it is to be hoped that this problem of multiple and overlapping regulation will be recognized and dealt with in accordance with the principle of comity.⁸ However, existing laws were, in most cases, drafted without the possibility of cross-border transactions in mind, and in many cases their application extends far beyond what was envisaged at the time of enactment.⁹

This problem of the multiple applicability of national laws arises on at least the following two levels:

??Private law claims by a person in one country against an online actor in another country, which are subject to the laws and jurisdiction of the claimant's country. This Article does not examine these issues.¹⁰

??Claims by a state to regulate activities which have effects in its territory, even though the person or corporation to

6. See, e.g., CANADA'S TAX ADMINISTRATION, *supra* note 1, § 4.2.2.5 (positing that electronic commercial activity can lead to multiple countries asserting jurisdiction over that activity regardless of physical and national boundaries).

7. Refer to Part II.A *infra* (discussing issues posed by online advertisements).

8. Refer to Part V *infra* (providing an example relative to electronic signatures).

9. See, e.g., CANADA'S TAX ADMINISTRATION, *supra* note 1, § 3.1 (commenting on non-federal U.S. telecommunication laws that are often obsolete but are still enforced to maintain short-term tax revenues, even at the expense of long-term growth of electronic commerce). *But see, e.g.*, Use of Internet to Offer Services Offshore, Securities Act Release No. 7516, Securities Exchange Act Release No. 39779, Investment Advisers Act Release No. 1710, Investment Company Act Release No. 23,071, International Series Release No. 1125, 63 Fed. Reg. 14,806, 14,808 n.19 (Mar. 23, 1998) [hereinafter Use of Internet to Offer Services Offshore], available at 1998 WL 135626 (noting that forty-seven states are exempting Internet offers from the securities registration provisions when the offers are not specifically directed to their residents).

10. The author has made a first attempt at so doing in CHRIS REED, INTERNET LAW: TEXT AND MATERIALS ch. 7 (Butterworths 2000).

whom the regulation is claimed to apply is acting online from a different state.¹¹

This Article examines the second of these levels via an analysis of the existing financial services regulation of the European Union (EU), which is currently evolving a mechanism for dealing with cross-border financial services transactions which might otherwise be subject to the regulations of each of the fifteen EU member states. The nature of the problem can be stated quite simply—the starting point for each regulator in those states, before the process of creating the Single Market began, was:

??My financial services regulation applies in your (the supplier's) jurisdiction because you are transacting financial services business with my citizens, even though you have no presence here; and

??Your commercial activities are occurring (in part) in my jurisdiction, thus my laws apply to those parts of your activities.¹²

To understand these issues, it is useful to bear in mind the example of a non-EU corporation (for example, a U.S. corporation) that wishes to sell financial services (investment, banking and insurance products, and brokerage services) in all EU member states using online means, thus avoiding any physical presence there.

II. CROSS-BORDER SUPPLIES OF FINANCIAL SERVICES ARE PRIMA FACIE UNLAWFUL

The online sale of financial services is an ideal application for e-commerce.¹³ The technology can enable a U.S. provider to sell almost all types of financial products to EU customers

11. See, e.g., Use of Internet to Offer Services Offshore, *supra* note 9, at 14,806 (recognising that companies are unsure about application of U.S. securities laws to Internet offers originating outside the United States but accessible in the United States); FINANCIAL SERVICES AUTHORITY, TREATMENT OF MATERIAL ON OVERSEAS INTERNET WORLD WIDE WEB SITES ACCESSIBLE IN THE UK BUT NOT INTENDED FOR INVESTORS IN THE UK paras. 1–2 (1998) [hereinafter FIN. SERVICES AUTH.] (noting that firms with no permanent UK place of business and no UK authorization are concerned about potential criminal liability because their Web site material may be accessible to UK investors), available at http://www.fsa.gov.uk/pubs/guidance/gr02_1998.pdf#.

12. See, e.g., FIN. SERVICES AUTH., *supra* note 11, at paras. 10–11 (discussing the applicability of UK regulation to electronic advertisements issued outside the UK but accessible in the UK).

13. See, e.g., Use of Internet to Offer Services Offshore, *supra* note 9, at 14,807; FIN. SERVICES AUTH., *supra* note 11, at para. 5 (noting the significance of the Internet in giving detailed and current information to investors).

without establishing any infrastructure outside the United States as all modern financial services transactions are, at heart, merely transfers of accounting information from one database to another.¹⁴ However, such cross-border sales are unlawful under the laws and regulations of the customer's country if the U.S. corporation holds only the relevant U.S. federal or state licenses for its financial services offerings and is not licensed and supervised in an EU jurisdiction.¹⁵ This is because:

?? Advertising those financial services via a Web site to EU customers is a criminal offence;¹⁶ and

?? Supplying those services to EU customers is (possibly) also an offence.¹⁷

This is almost certainly true in all other countries that have a developed banking and financial services regime.¹⁸ Theoretically, there is a solution—obtaining a license and becoming supervised in every jurisdiction where customers are sought. In practice, the burden of regulatory compliance is too great to make this solution economical.

A. *Advertising Financial Services*

Advertising controls for financial services are extensive in most jurisdictions and present a real problem for commercial users of the Internet. By definition, an intended commercial communication will not become an advertisement until it is read, or at least readable, by potential customers.¹⁹ It is this act of communication that constitutes advertising, and the logical

14. For example, if A sells securities to B, that sale is effected via the following information transfers:

?? A's nominee account on the relevant exchange is debited with that number of shares;

?? B's nominee account is credited with the same number of shares;

?? B's bank account is debited with the amount of the transaction;

?? A's bank account is credited with the amount of the transaction; and

?? The two banks alter their debit and credit balances in their accounts with each other and with their central banks. In cross-border transactions this may involve other correspondent banks and national clearing systems.

There is no need for any physical movement of property (including paper) to complete all aspects of the transaction.

15. See, e.g., Financial Services and Markets Act, 2000, c. 8, § 19 (Eng.) (requiring firms to obtain authorization to carry on regulated financial activities in the UK), available at <http://www.hmsso.gov.uk/acts/acts2000/20000008.htm> (last visited Sept. 22, 2001).

16. See, e.g., *id.* §§ 21(1), 25(1).

17. See, e.g., *id.* §§ 19(1), 22–23(1).

18. Refer to notes 24–28 *infra* and accompanying text for restrictions on financial services in the United States.

19. See, e.g., FIN. SERVICES AUTH., *supra* note 11, at para. 11.

conclusion is that the advertising takes place where the potential customer sees the communication.²⁰ In the case of a Web page advertisement, that place is the reader's computer. Thus, the jurisdiction is where the reader is physically located. The law which regulates that particular instance of the advertisement will therefore be the law of the place of reading.²¹

In highly regulated sectors, such as financial services, it is usually a criminal offense to issue an advertisement—irrespective of its truth and accuracy—unless the issuer is authorized by the national regulatory body.²² The recent UK consolidation of financial services regulation in the Financial Services and Markets Act 2000 makes this clear in Chapter 8, section 21, which provides: “(1) A person . . . must not, in the course of business, communicate an invitation or inducement to engage in investment activity” unless that person is authorized by the regulator or the advertisement is approved by an authorized person.²³ The U.S. legislation is more diverse,²⁴ but produces the same overall effect by requiring registration of any interstate securities offering with the Securities and Exchange

20. See, e.g., *id.* at para. 10.

21. The Financial Services Authority (FSA) treats any advertisements viewed on a computer screen in the UK as having been issued in the UK with certain qualifications:

10. . . . It is the FSA's view that, for the purposes of the Act [of the Financial Services Act of 1986], an advertisement which can be accessed on a computer screen by a person in the UK, will have been issued in the UK, but there is an important qualification to this for material issued outside the UK. The qualification appears in section 207(3) which sets out particular circumstances in which an investment advertisement issued outside the UK is to be treated as issued in the UK. This is particularly relevant to the operation of the Internet.

11. Broadly speaking, section 207(3) provides that an advertisement issued outside the UK will be treated as having been issued in the UK if it is either “directed at” people in the UK or “made available” to them other than by way of a periodical publication published and circulating principally outside the UK (or in a sound or television broadcast transmitted principally for reception outside the UK). It is possible that an electronic publication could fall within the definition of a “periodical publication” (this will depend on the precise facts in each case) but the FSA considers that Internet material is not “a sound or television broadcast.” So, much of the information on the Internet may be viewed, for the purposes of determining whether section 57(1) applies, as having been issued in the UK as it is “made available” to persons in the UK.

Id. at paras. 10–11. See also Use of Electronic Media for Delivery Purposes, Securities Act Release No. 7233, 60 Fed. Reg. 53,458, 53,464 (Oct. 6, 1995) (“The placing of the offering materials on the Internet would not be consistent with the prohibition against general solicitation or advertising in Rule 502(c) of Regulation D.”).

22. See, e.g., Financial Services and Markets Act, 2000, c. 8 § 21(1) (Eng.). Refer to notes 24–28 *infra* and accompanying text for authorization requirements of advertisements in the United States.

23. Financial Services and Markets Act § 21(1).

24. See generally Use of Internet to Offer Services Offshore, *supra* note 9, at 14,806–13 (providing a helpful analysis of U.S. legislation).

Commission (SEC).²⁵ This prohibits foreign investment companies from using any means of interstate commerce in the United States to publicly offer securities,²⁶ prohibits use of means of interstate commerce for providing unregistered investment advice,²⁷ and requires registration and reporting of interstate activities by brokers or dealers.²⁸ In addition to criminal sanctions, the consequences of failure to register may even render unenforceable any transaction entered into with customers in that jurisdiction.²⁹

Even regulators recognize that worldwide registration is impracticable³⁰—although there are, as yet, no proposals to limit radically the application of the relevant laws. Some regulators have, however, attempted to mitigate the impossibility of the current situation by issuing statements about their *enforcement* policy, stating that, in practice, they will not take action against an advertiser unless the advertisement is targeted at customers in their jurisdiction.³¹

The question which remains to be answered is what constitutes “targeting.” Here there are two possible approaches:

?? An advertiser does not target a jurisdiction if the advertisement is not accessible to customers in that jurisdiction;³² or

?? Even though the advertisement is accessible, targeting will not have taken place if there are adequate measures in place to prevent customers in that jurisdiction from purchasing the financial products or services.³³

The UK Financial Services Authority (FSA) initially adopted the first approach³⁴ but this was widely criticized as unworkable. In effect, a financial services company would have been required to prevent readers from viewing any part of its Web site that

25. Securities Act of 1933 § 5, 15 U.S.C. § 77e (1994).

26. Investment Company Act of 1940 § 7(d), 15 U.S.C. § 80a-7(d) (1994).

27. Investment Advisers Act of 1940 § 203(a), 15 U.S.C. § 80b-3(a) (1994 & Supp. 2000).

28. Securities Exchange Act of 1934, §§ 6, 15(a), 15 U.S.C. §§ 78f, 78o(a) (1994).

29. See, e.g., Financial Services and Markets Act, 2000, c. 8, §§ 27–28 (Eng.).

30. Use of Internet to Offer Services Offshore, *supra* note 9, at 14,808.

31. See *id.* at 14,807 (clarifying that U.S. securities laws do not require registration for Internet offers not targeted to the United States).

32. See, e.g., FIN. SERVICES AUTH., *supra* note 11, at para. 12 (emphasizing that online investment information would not be considered “made available” if UK citizens could not access the information).

33. See, e.g., Use of Internet to Offer Services Offshore, *supra* note 9, at 14,808–13.

34. FSA Guidance Letter, *Advertising over the Internet* (June 1996), at <http://www.fsa.gov.uk>.

constituted an investment advertisement under the Financial Services Act 1986 unless the reader certified that he or she was not viewing the site from the UK.³⁵ The current UK policy mixes the two approaches, although the FSA still appears to believe that access restriction is a practicable matter.³⁶ The most recent guidance note suggests that relevant factors will be the following:

[T]he extent to which positive steps had been taken to ensure that UK investors did not obtain the investment service as a result of an advertisement having been issued over the Internet. This would include whether the person issuing or causing the investment advertisement to be issued had systems in place to ensure that the service could be received only by persons who may lawfully receive it (which would include, for example, an effective system[] for ascertaining the country of origin of an individual who attempts to open an account to purchase or to request further information regarding investment services on the site).³⁷

But a footnote to this statement adds:

The “positive steps” might include requiring pre-registration (and the issuing of passwords) to ensure that only those to whom the material was aimed had access. However, if it was in fact possible to circumvent the pre-registration process or if the pre-registration did not form a substantive check to access (for instance if you only had to “click here” to confirm you were not from the UK), then clearly it would be difficult to argue that the material had not been “made available” for the purposes of section 207(3) of the Act.³⁸

As a consequence of the UK Financial Services and Markets Act 2000, this advice may change. Section 21(3) provides that, “[i]n the case of a communication originating outside the United Kingdom, subsection (1) [the prohibition] applies only if the communication is capable of having an effect in the United Kingdom.”³⁹ On the assumption that mere communication of information—without the possibility of any transaction taking place (because of other controls)—is not capable of having an

35. See FIN. SERVICES AUTH., *supra* note 11, at para. 16(b)–(c).

36. See *id.* at paras. 16(b)–(18) (clarifying the combination of the strict approach of advertisement availability and measures to prohibit sales with the more flexible considerations of whether the advertisement was targeted to UK persons).

37. *Id.* at para. 16(c) (citation omitted). “An example of an ineffective system would be one which permits a visitor to the site to purchase products or services simply by ‘clicking’ a box to state that he was not from the UK.” *Id.* at para. 16 n.6.

38. *Id.* at para. 16 n.7.

39. Financial Services and Markets Act, 2000, c. 8, § 21(3) (Eng.).

effect in the UK, it is possible that the FSA will move closer to the U.S. position.⁴⁰

In the United States, the SEC is responsible for authorizing financial services advertisements, and its statement on enforcement policy adopts the second approach.⁴¹ The most important factor in deciding whether to enforce the relevant law is whether the advertiser has taken reasonable steps to prevent U.S. persons from purchasing products or services.⁴² The SEC statement on this issue provides that enforcement activity will not be taken if the Web site states that no business will be undertaken in the United States or with U.S. persons and if, in addition, reasonable measures are put in place to prevent such transactions.⁴³ Part III.C of that statement helpfully recognizes that reasonable measures cannot be expected to prevent *all* such transactions and states:

In our view, if a U.S. person purchases securities or investment services notwithstanding adequate procedures reasonably designed to prevent the purchase, we would not view the Internet offer after the fact as having been targeted at the United States, absent indications that would put the issuer on notice that the purchaser was a U.S. person. This information might include (but is not limited to): receipt of payment drawn on a U.S. bank; provision of a U.S. taxpayer identification or social security number; or, statements by the purchaser indicating that, notwithstanding a foreign address, he or she is a U.S. resident. Confronted with such information, we would expect offerors to take steps to verify that the purchaser is not a U.S. person before selling to that person. Additionally, if despite its use of measures that appear to be reasonably designed to prevent sales to U.S. persons, the offeror discovers that it has sold to U.S. persons, it may need to evaluate whether other measures may be necessary to provide reasonable assurance against future sales to U.S. persons.⁴⁴

40. For a more detailed discussion of targeting under the UK legislation, see Lars Davies, *From Uncertainty to Uncertainty: Developments in Securities Law and the Internet in the United Kingdom*, 12 COMPLIANCE MONITOR 71 (1999).

41. See Use of Internet to Offer Services Offshore, *supra* note 9, at 14,807–09 (describing accessible advertisements with measures to prevent actual sales to U.S. persons as not targeting the United States).

42. See *id.* at 14,813 (listing examples of reasonable steps to prevent securities transactions in the United States).

43. *Id.*

44. *Id.* at 14,808–09.

Enforcement policies of this kind may provide some short-term comfort to Internet businesses. In the long term, however, they are likely to prove unworkable because the potential online market is worldwide.

B. Supplying Financial Services in the Jurisdiction

Most financial services regulations apply not only to activities undertaken from a permanent establishment in the jurisdiction, but also to specified activities carried out there by other means.⁴⁵ The difficulty lies in deciding precisely where these activities take place when they are effected through electronic communications. It is at least arguable that—where national laws simply prohibit unlicensed activities within the jurisdiction—such prohibitions are not infringed by many types of financial services transactions.

This argument is based on the fact that the core element of all financial services activities, with the probable exception of giving financial advice,⁴⁶ is the manipulation of account data. This is true for such matters as bank account transactions, share dealings,⁴⁷ and dealings in investment funds. Although there may be underlying “real” assets,⁴⁸ the service for which the customer is paying consists of transmitting messages and

45. See, e.g., Financial Services and Markets Act, 2000, c. 8 §§ 19(1), 21–22 (Eng.) (requiring authorization for pursuing regulated financial activities in the UK regardless of the origin of the activity). *But see*, e.g., Council Directive 2000/12/EC art. 1, 2000 O.J. (L 126) 1, 2, 12 [hereinafter Banking Directive] (directing, in the context of the European Union, that the “home member state,” i.e., the place of permanent establishment, may require authorization for financial services, but that the “host member state,” i.e., where the credit institution has a branch or simply provides services, may not require authorisation).

46. It is arguable that advice is given where it is received because, until that point, it is merely potential advice. However, for European Value Added Tax (VAT) purposes, it is clear this advice would be treated as a service provided in the advisor’s jurisdiction, were it not for the reverse charge provisions of VAT law. Council Directive 77/388/EEC, arts. 9(2)(e), 21(1)(b), 1977 O.J. (L 145) 1. A contrary position (for non-VAT purposes) has been taken by the UK courts which have held that the giving of advice by means of software installed on the user’s computer, running without further intervention on the part of the author, is nonetheless given by the author. *Re Market Wizard Systems (UK) Ltd.*, 2 BCLC 282, 282 (1998). It has been suggested that the same reasoning should apply to make the operator of a Web site liable for advice given via automated means from that Web site. Davies, *supra* note 40, at 71.

47. This is at least true on modern dematerialized securities exchanges, where the dealings are in undifferentiated quantities of shares from nominee accounts rather than numbered shares identified by physical certificates. See, e.g., Uncertificated Securities Regulation, (1995) SI 1995/3272, § 2(1) (enabling title to units of a security in the UK to be evidenced and transferred digitally as well as in paper).

48. Even in terms of assets, though, most are “unreal” in the sense that they are merely debts evidenced by data relating to another account. Typical examples for a bank include loans made to its customers and Certificates of Deposit with the central bank.

modifying account data. For cross-border sales, these generally take place in the supplier's jurisdiction, not the customer's. Thus, if a bank customer uses the Internet to instruct his bank to pay a bill, the required service is the transmission by the bank of an appropriate payment message and the consequential amendment of the customer's account data. Both of these activities take place on the bank's computers, in the bank's jurisdiction.⁴⁹

From a regulator's perspective, this might appear undesirable, as such an approach would permit a business which could operate purely via electronic communications to establish itself abroad but sell its services within the regulator's jurisdiction without being subject to the regulator's control. For this reason, some national laws have been structured in such a way as to extend the regulator's jurisdiction to cover remote sales.

For example, the UK Financial Services and Markets Act 2000 deals with the problem of deciding where a business activity takes place by extending the range of business activities covered.⁵⁰ The basic prohibition is set out in section 19(1) of the Act which provides: "No person may carry on a regulated activity⁵¹ in the United Kingdom, or purport to do so, unless he is

49. The difficulty in locating the proper jurisdiction was noted as follows:

The growth of distance services, particularly those using electronic means (Internet, home banking, etc.), will undoubtedly soon result in excessively strict criteria on location becoming obsolete.

The Commission has examined certain possibilities for locating the service (originator of the initiative, customer's place of residence, supplier's place of establishment, place where contracts are signed, etc.) and considers that none could satisfactorily apply to all the activities listed in the Annex.

It considers it necessary to adhere to a simple and flexible interpretation of Article 20 of the Second Directive. Accordingly, in its opinion, only activities carried on *within the territory* of another Member State should be the subject of prior notification. In order to determine where an activity was carried on, the place of provision of what may be termed the "characteristic performance" of the service, i.e. the essential supply for which payment is due must be determined.

. . . [T]he provision of distance banking services, for example through the Internet, should not, in the Commission's view, require prior notification, since the supplier cannot be deemed to be pursuing its activities in the customer's territory.

Commission Interpretative Communication, Freedom to Provide Services and the Interest of General Good in the Second Banking Directive, 1997 O.J. (C 209) 6-7 [hereinafter Freedom to Provide Services].

50. See Financial Services and Markets Act, 2000, sch. 2, pt. 1 (Eng.).

51. These are listed in Schedule 2 of the Act:

- ?? Dealing in investments;
- ?? Arranging deals in investments;
- ?? Deposit taking;
- ?? Safekeeping and administration of assets;

(a) an authorised person, or (b) an exempt person in relation to that activity.”⁵²

If the prohibition merely covered performing these activities, then in most cases performance would occur on the seller’s computer systems and thus potentially outside the UK. However, Schedule 2 of the Financial Services and Markets Act expressly states that, with the exception of deposit taking, performance of all these activities includes offering or agreeing in the UK to undertake the activity.⁵³ Thus, unless the seller can structure his operations so that no offer or agreement takes place in the UK, the UK regulator will have jurisdiction over a foreign Internet supplier of financial services to UK-based customers.⁵⁴

Even where the relevant national law has not been modified or interpreted so as to apply specifically to online sales in the jurisdiction, the argument set out above is unlikely to be tested in the courts. Few financial services companies will be prepared to risk selling into that jurisdiction on the basis of what is, at best, a fairly metaphysical argument about the geographical location of non-physical assets and activities.

III. THE CURRENT EU LAW—A PARTIAL SOLUTION?

The current state of EU law provides a partial solution to this problem. If a U.S. corporation creates a permanent establishment in *one* EU member state—for example, by way of a branch or a subsidiary corporation with its seat in that country—it may apply for the appropriate financial services licenses from the relevant supervising bodies in that EU member state.⁵⁵ Once these licenses are granted the corporation can, in theory, take advantage of the Single Market regime to supply cross-border to the other fourteen EU states.⁵⁶

?? Managing investments;

?? Giving investment advice;

?? Establishing collective investment schemes;

?? Using computer-based systems for giving investment instructions.

Id.

52. *Id.* § 19(1) (internal citation added).

53. *Id.* at sched. 2, pt. 1.

54. *Id.* § 19(1) & sched. 2, pt. 1.

55. See, e.g., Banking Directive, *supra* note 45, at para. 14.

56. See, e.g., Proposal for a European Parliament and Council Directive on Certain Legal Aspects of Electronic Commerce in the Internal Market, Explanatory Memorandum, art. 3, 1999 O.J. (C 30) 4 [hereinafter Proposal on Electronic Commerce] (expressing the intent of EU law to determine a home EU member state for a given company, and then to prohibit other EU member states, i.e., host member states, from restricting that company’s freedom to provide certain financial services); Directive on Electronic Commerce, *supra* note 5, art. 3, at 9 (declaring that member states may not

A. *Permanent Establishment Under EU Law*

Having a permanent establishment in the relevant jurisdiction is the normal trigger for the application of that jurisdiction's financial services regulation to a commercial enterprise.⁵⁷ Permanent establishment is a somewhat elastic concept, however. Even in the physical world, it is possible to undertake trading activities in another state, through the means of agents or distance selling techniques such as telephone marketing, which do not require the business to occupy premises or possess business equipment located in that state.

In the context of banking services, the European Court of Justice has attempted a definition of permanent establishment in *Somafer SA v. Saar-Ferngas AG*:

The concept of branch, agency or other establishment implies a place of business which has the appearance of permanency, such as the extension of a parent body, has a management and is materially equipped to negotiate business with third parties so that the latter, although knowing that there will if necessary be a legal link with the parent body, the head office of which is abroad, do not have to deal directly with such parent body but may transact business at the place of business constituting the extension.⁵⁸

In essence, this ruling sets out the following three requirements for defining permanent establishment, which are also reflected in other areas of regulation:⁵⁹

??The use of fixed premises or equipment in the state;

??The presence of staff (which may include some intermediaries who act as agents for the enterprise); and

restrict other member states from providing information society services, e.g., financial services); Banking Directive, *supra* note 45, at paras. 7, 14 & art. 13 (directing that the license granted to a bank by one member state will be accepted throughout the Community, and that other member states are not to require additional authorization); Amended Proposal for a European Parliament and Council Directive Concerning the Distance Marketing of Consumer Financial Services and Amending Directives 97/7/EC and 98/27/EC, paras. 2, 4, 2000 O.J. (C 177E) 21 [hereinafter Amended Proposal on Distance Marketing] (explaining that, upon completion of the single EU market, distance marketing of financial services will permit consumers to deal with suppliers outside the consumer's country).

57. See, e.g., Financial Services and Markets Act, 2000 c. 8, § 418 (Eng.).

58. Case 33/78, *Somafer SA v. Saar-Ferngas AG*, 1978 E.C.R. 2183.

59. See, e.g., CANADA'S TAX ADMINISTRATION, *supra* note 1, § 4.2.2.4 (characterizing "permanent establishment" for tax purposes as a fixed place of business, or as a non-resident's use of a resident agent who habitually exercises authority in the name of the non-resident).

??The ability of those staff to undertake business transactions with customers in the state.⁶⁰

Immediately, it can be seen that if this interpretation of the concept of establishment is applied to Internet activities from a foreign jurisdiction, the fact that the supplier's Web site appears (temporarily) on the customer's computer will not be sufficient to create a virtual branch.⁶¹ The supplier has no premises or staff in the jurisdiction, the computer equipment is used only temporarily, and, in any event, the computer belongs to the customer.

A more difficult issue arises, however, if the supplier's Web site is stored on a server in the jurisdiction.⁶² Even if the Web site runs from a server that is both owned by the supplier and located in a premises owned or rented by him, and maintained by his employees, not all the requirements of a permanent establishment are met.⁶³ There are still no staff in that jurisdiction who have authority to contract with customers—that function is performed by software running on the server.

So far as banking services are concerned, the European Commission appears to have accepted this argument in its *Freedom to Provide Services and the Interest of the General Good in the Second Banking Directive*:

Unlike other services, where the place of supply can give rise to no doubts (legal defence, construction of a building, etc.), the banking services listed in the Annex to the Second Directive are difficult to pin down to a specific location. They are also very different from one another and are increasingly provided in an intangible form. The growth of distance services, particularly those using electronic means (Internet, home banking, etc.), will undoubtedly soon result in excessively strict criteria on location becoming obsolete. . . . For [technical equipment such as an ATM] to be capable of being treated as an establishment . . . it would have to have a management, which is by definition impossible unless the Court acknowledges that the concept

60. See *Case 33/78, Somafer SA*, 1978 E.C.R. at 2183.

61. See CANADA'S TAX ADMINISTRATION, *supra* note 1, § 4.2.2.4 (contending that the location of the customer logged on to the company Web site does not have the required element of permanence to be considered a fixed place of business).

62. Operating from multiple Web sites can be a sensible electronic commerce strategy because of the communication bottlenecks which arise as Internet traffic crosses difficult geographic boundaries such as oceans. A global electronic commerce supplier might well choose to operate Web sites in each of the major continents for precisely this reason.

63. Note, however, that such a business structure might be sufficient to create a taxable presence. Refer to note 66 *infra* and accompanying text.

can encompass not only human management but also electronic management. . . . The presence in the host country of a person or company responsible simply for maintaining the machine, equipping it and dealing with any technical problems encountered by users cannot rank as an establishment and does not deprive the credit institution of the right to operate under the freedom to provide services. The Commission considers, however, that technological developments could, in the future, induce it to review its position. If such developments were to make it possible for an institution to have only a machine in a given country which could “act” as a branch, taking actual decisions which would completely obviate the need for the customer to have contact with the parent company, the Commission would be forced to consider an appropriate Community legal framework. The present legal framework in fact rests on mechanisms which are still based on a “human” concept of a branch (for example, the programme of operations must contain the names of those responsible for the management of the branch). It is therefore not possible, under the existing rules, to consider machines as constituting a branch.⁶⁴

The last part of this passage recognizes that Internet financial services Web sites can act autonomously, as replacements for physical branches, without being subject to the same regulation as branches, because they do not constitute a permanent establishment. However, this does not free a non-EU financial services corporation to supply services into the EU free of EU regulation, because its activities still will amount to either unlawful advertising or unlawfully doing business in the jurisdiction.⁶⁵

This definition of permanent establishment is not the only way of approaching the issue. For the purposes of income and corporation tax, the OECD Committee on Fiscal Affairs has

64. Freedom to Provide Services, *supra* note 49, at 6, 13. See also Proposal on Electronic Commerce, *supra* note 56, at 20.

Thus, the following, for example, do not amount to an establishment on the territory of a Member State:

- *the location of the technology used*, e.g. the hosting of web pages or of a site;
- *the ability to access an internet site* in a Member State (any other approach would mean that an operator would be considered to be established in several or indeed fifteen Member States);
- the fact that a service provider established in another Member State offers *services targeted* at the territory of another Member State (in fact, the internal market enables businesses, particularly SMEs, to tailor their offers to specific niche markets in other Member States).

Id. (emphasis added).

65. Refer to Part II.A & B *supra*.

proposed that a Web site hosted on a server—where the server is a business asset of the enterprise—could be treated as a permanent establishment of the enterprise.⁶⁶ However, if the Web site is merely hosted by an independent Internet Service Provider (“ISP”), and there is no equipment or premises controlled exclusively by the enterprise, the enterprise would have no permanent establishment in the jurisdiction.⁶⁷ Even if this definition were to be adopted for financial services, however, it is unlikely that our hypothetical U.S. corporation would need exclusive use of a server located within the EU to carry on its sales activities.

To take advantage of the European Single Market, the U.S. financial services corporation must create a permanent establishment in one EU member state and secure the appropriate licenses and permission to undertake financial services business.⁶⁸ Unfortunately, the current position in the EU does not confer such substantial advantages on the corporation as might at first be imagined. Although there is a theoretical freedom to supply services cross-border, in practice there are so many national law exceptions to this freedom that it is largely illusory.⁶⁹

B. *The Single Market*

The various elements of the EU Single Market in services are based on country of origin regulation (also known as home country regulation).⁷⁰ The principles of country of origin regulation are simple:

??By mutual agreement two states, or a group of states collectively, provide that activities of an organization

66. OECD COMMITTEE ON FISCAL AFFAIRS, CLARIFICATION ON THE APPLICATION OF THE PERMANENT ESTABLISHMENT IN E-COMMERCE: CHANGES TO THE COMMENTARY ON THE MODEL TAX CONVENTION ON ARTICLE 5, para. 42.3, at 5 (Dec. 22, 2000), available at http://www.oecd.org/daf/fa/e_com/ec_1_PE_Eng.pdf.

67. *Id.* at para. 6, at 3.

68. Refer to notes 55 and 56 *supra* and accompanying text (discussing the single-license concept for providing financial services to the EU).

69. Refer to Part III.C *infra* (discussing legal limitations on cross-border activities in the EU).

70. See Communication from the Commission to the Council and the European Parliament—E-Commerce and Financial Services, Executive Summary, COM(01)66 final [hereinafter *ECommerce and Financial Services*] (indicating the Commission will facilitate a country-of-origin approach to cover distance trading and other financial services); Opinion of the Economic and Social Committee on the ‘Proposal for a European Parliament and Council Directive in Certain Legal Aspects of Electronic Commerce in the Internal Market,’ §§ 3.6, 3.6.2, 1999 O.J. (C 169) 36, 38 (endorsing the country-of-origin principle that laws of the country in which the service provider is established apply).

which are established and regulated in one state (the home state) may be carried out in another (the host state) without any requirement for prior authorization from, or supervision by, the appropriate regulatory body in the host state;⁷¹

??The basis of this agreement is an assessment by all participating states that the others operate systems of authorisation and/or supervision which are adequate to achieve the aims of the home state's regulatory system;⁷²

??The laws of the host state still will apply as follows:

- (i) To the appropriate aspects of individual transactions undertaken in the state, for example, the law of contract or consumer protection law;⁷³ and
- (ii) Where the host state's law or regulation has overriding effect, for example, laws designed for the protection of national security.⁷⁴

One of the first, and still the most extensive and well-developed, multilateral schemes of country of origin regulation is the EU "single passport" for banking services.⁷⁵ All the states making up the European Economic Area⁷⁶ have implemented legislation that transposes into national law the First and Second Banking Directives and other related legislation (now consolidated as the Banking Directive⁷⁷). The net effect of these national laws, which are, in theory, identical in effect if not in wording, is to create a pan-European system under which a credit institution that is established in and regulated by one country is free to provide banking services in all the others.⁷⁸

71. See, e.g., Banking Directive, *supra* note 45, art. 1, paras. 6-7, at 12 (defining "home member state" as a "Member State in which credit institution is authorised," and "host member state" as a "Member State in which credit institution has a branch or provides services").

72. See, e.g., *id.* at para. 8, at 2 (noting that participating states should have equivalent requirements for credit institutions).

73. See, e.g., Directive on Electronic Commerce, *supra* note 5, art. 3, para. 4, at 9-10.

74. *Id.*

75. See, e.g., Proposal for a Council Directive on Investor Compensation Schemes, Explanatory Memorandum, 1993 O.J. (C 321) 15 (describing the Second Banking Directive 89/646, 1989 O.J. (L 386) 1 (EEC), effective on Jan. 1, 1993, as providing a single license for credit institutions).

76. The Single Market extends by treaty beyond the EU member states to a number of other European states that collectively make up the EEA. Agreement on the European Economic Area—Final Act, art. 126, 1994 O.J. (L 1) 3.

77. See, e.g., Banking Directive, *supra* note 45, at para. 1, at 1.

78. See, e.g., *id.* at para. 7 (permitting a single license for a credit institution to be

Similar EU initiatives in the related fields of investment services⁷⁹ and insurance⁸⁰ are creating comparable schemes for those fields of activity.

The Single Market is only complete, however, for the core banking sector.⁸¹ For investment services and insurance, many national law requirements that impose limitations on cross-border sales activity remain in existence.⁸² An online financial services corporation established in one EU member state still has to comply with those regulations when selling into the other member states.

C. Limitations on Cross-Border Activity

1. *Derogations Justified by the "General Good."* The basis of country of origin regulation is not that the regulation by home and host country is the same, but that it is broadly equivalent and thus provides a level of regulatory control that is an acceptable minimum in each of the participating states.⁸³ It is therefore tempting for a host country to wish to apply certain elements of its own regulatory system to foreign providers of services—notwithstanding the multilateral or bilateral

accepted throughout the Community, with supervision by the member state that granted the license); E-Commerce and Financial Services, *supra* note 70, Executive Summary, parts. 1–2 (proclaiming the Commission's goal of building a fully integrated European financial services market by 2005, and explaining that providers may supply services electronically throughout the Community per the laws of the member states in which the providers are established, i.e., per laws in the country of origin).

79. See, e.g., Council Directive 93/22/EEC, 1993 O.J. (L 141) 11.

80. See, e.g., Council Directive 92/49/EEC of 18 June 1992 on the Coordination of Laws, Regulations and Administrative Provisions Relating to Direct Insurance Other Than Life Assurance and Amending Directives 73/239/EEC and 88/357/EEC (Third Non-Life Insurance Directive), para. 6 and art. 9, 1992 O.J. (L 311) 1 (directing that for insurance business other than in life insurance, a single license granted by a member state will be accepted throughout the community with supervision by the member state that granted the license); Council Directive 92/96/EEC of 10 November 1992 on the Coordination of Laws, Regulations and Administrative Provisions Relating to Direct Life Assurance and Amending Directives 79/267/EEC and 90/619/EEC (Third Life Assurance Directive), para. 6 and art. 8, 1992 O.J. (L 360) 1 (directing that for the selling of life insurance, a single license granted by a member state will be accepted throughout the community, with supervision by the member state that granted the license).

81. See Neil B. Murphy, *European Union Financial Developments: The Single Market, the Single Currency, and Banking*, 13 FDIC BANKING REVIEW 6 (2000) (describing the single market program for banking as "in place"), available at http://www.fdic.gov/bank/analytical/banking/2000may/2_13nl.pdf (last visited Sept. 22, 2001).

82. See E-Commerce and Financial Services, *supra* note 70, at 12 (recognizing that the widespread use of host country legislation creates additional barriers to successful cross-border marketing of investment services).

83. Financial Services: Meeting Consumers' Expectations, Green Paper From the European Commission, COM(96)209 final at 3 [hereinafter Meeting Consumers' Expectations].

agreement establishing the country of origin principle. An essential element of such agreements is, therefore, the establishment of the limits on the host country's ability to apply its national regulations.⁸⁴ In the EU, whose single market project has resulted in extensive jurisprudence on the topic,⁸⁵ departure from the country of origin principle is normally only justified if it is for "the general good."⁸⁶ A specific right to derogate on this ground is found in all the single market financial services legislation.⁸⁷

Perhaps the clearest—and certainly the most modern—definition of the general good is found in Article 3(4)(a) of the Electronic Commerce Directive,⁸⁸ which provides that measures derogating from the country of origin principle of Article 3(2) must be:

(i) necessary for one of the following reasons:

?? public policy, in particular the prevention, investigation, detection and prosecution of criminal offences, including the protection of minors and the fight against any incitement to hatred on grounds of race, sex, religion or nationality, and violations of human dignity concerning individual persons,

?? the protection of public health,

84. See, e.g., E-Commerce and Financial Services, *supra* note 70, at 7 (indicating that the "internal market clause," which prohibits member states from restricting the freedom of other member states to provide services, is central to the E-Commerce Directive).

85. See, e.g., Case C-76/90, *Säger v. Dennemeyer & Co.*, 1991 E.C.R. I-4221 (1991) (limiting a host state's ability to restrict patent renewal services provided from another member state); Case 205/84, *Commission v. Germany*, 1986 E.C.R. 3755, para. 4 (1986) (restricting member state regulations that impinge on the freedom to provide services); Case C-11/95, *Commission v. Belgium*, 1996 E.C.R. 4115, para. 3 (1996) (preventing a member state from adopting measures intended to nullify another member state's breach of the rules of Community law).

86. Case 205/84, *Commission v. Germany*, 1986 E.C.R. 3755, para. 27 (1986). The general good encompasses a wide range of interests; those so far recognised by the European Court of Justice are:

protection of the recipient of services, protection of workers, including social protection, consumer protection, preservation of the good reputation of the national financial sector, prevention of fraud, social order, protection of intellectual property, cultural policy, preservation of the national historical and artistic heritage, cohesion of the tax system, road safety, protection of creditors and protection of the proper administration of justice.

Freedom to Provide Services, *supra* note 49, at 18 (citations omitted).

87. See, e.g., Banking Directive, *supra* note 45, at art. 22 (retaining a member state's ability to prevent or punish irregularities within its territories when such irregularities are contrary to the general good).

88. Directive on Electronic Commerce, *supra* note 5, at art. 3(4).

??public security, including the safeguarding of national security and defense,

??the protection of consumers, including investors;

(ii) taken against a given information society service which prejudices the objectives referred to in point (i) or which presents a serious and grave risk of prejudice to those objectives;

(iii) proportionate to those objectives[.]⁸⁹

In the context of the banking sector, derogations from the country of origin measures caused so many problems that the European Commission found it necessary in 1997 to issue a consultation document on the topic that set out the circumstances in which derogation would be legitimate.⁹⁰

An important element in assessing legitimacy is whether the derogation is proportionate—in other words, whether there is a less restrictive measure which would achieve the general good objective.⁹¹ In *Freedom to Provide Services*, the Commission explains that the position should be different when regulating services provided from outside the territory, in which case restrictions are less likely to be justifiable:

[The European Court of Justice] has consistently held that a Member State: “may not make the provision of services in its territory subject to compliance with all the conditions required for establishment and thereby deprive of all practical effectiveness the provisions of the Treaty whose object is, precisely, to guarantee the freedom to provide services.”

The Court has also held that restrictions on the freedom to provide services are even less acceptable in cases where the service is supplied “without its being necessary for the person providing it to visit the territory of the Member State where it is provided.”

This clarification is particularly relevant to banking services, which are increasingly supplied without physical movement on the part of the supplier.

89. *Id.*

90. *Freedom to Provide Services*, *supra* note 49, at 3 (recognizing that uncertainties in interpreting concepts like “freedom to provide services” and “the interest of the general good” were interfering with the free movement of banking services).

91. *Id.* at 23 (advocating using the principle of appropriateness to evaluate if a member state’s response to a risk is the least restrictive means to protect the general good).

The Court has likewise consistently held that it does not follow from the third paragraph of Article 60 of the Treaty that: "all national legislation applicable to nationals of that State and usually applied to the permanent activities of undertakings established therein may be similarly applied in its entirety to the temporary activities of undertakings which are established in other Member States."

Thus, depending on the circumstances, the same restriction applied in the interest of the general good could be adjudged proportionate in respect of a branch but disproportionate in respect of a temporary provider of services. The Commission considers, for example, that a Member State which imposes certain formalities on credit institutions (controls, registration, costs, communication of information, etc.) for reasons that purport to be in the general good should take account of the mode of operation chosen by the credit institution carrying on activities within its territory under mutual-recognition arrangements.

However, this distinction cannot be applied to consumer-protection rules (provided, of course, that they have satisfied the other tests). The level of consumer protection required must be identical, whether the service is supplied under the freedom to provide services or by way of establishment. It would be unacceptable for a consumer to be less well protected according to whether he received a service from a non-established undertaking or an established undertaking.

It may be necessary, however, to take account of the circumstances in which the service was requested. There may be situations in which the consumer has deliberately avoided the protection afforded him by his national law, particularly where he requests a service from a non-established bank without having first been canvassed in any way by that bank.⁹²

From this we may conclude that, because a common core of harmonization for licensing and supervision of the financial services sector has taken place, an attempt to impose national regulation on cross-border online activities is likely to be justified on the ground of consumer protection, and then only where the law and regulation of the country of origin do not provide equivalent protection. Even there, it may be inappropriate to apply national regulation where consumers contract with a

92. *Id.* at 24–25 (citations omitted).

foreign financial services supplier with the informed knowledge that their protections are lower.

2. *Retention of Local Conduct of Business Rules.* In practice, regulators throughout the EU have continued to impose their local conduct of business rules.⁹³ This is unsurprising—those rules must, by definition, have been introduced for reasons which seemed good to the regulator, and by extension what the *regulator* considers good must be equivalent to the *general* good. Regulators have even continued to impose local conduct of business rules on business-to-business financial services.⁹⁴ Although this reasoning is defective, such regulatory decisions can only be challenged through an action before the relevant national courts and, as part of those proceedings, by way of reference to the European Court of Justice.⁹⁵

There is insufficient space in this Article for a detailed discussion of European national conduct of business rules which have yet to be researched in depth, but some understanding of their extensiveness—and their effect as barriers to cross-border sales—can be gleaned from the list of potential problem areas set out in the European Commission's interpretative communication *Freedom to Provide Services and the General Good in the Insurance Sector*:

- (a) prior notification of policy conditions;
- (b) capital redemption operations of insurance undertakings;
- (c) uniform no-claims bonus systems;
- (d) language of the insurance policy;
- (e) professional codes of conduct;
- (f) maximum technical interest rates for life assurance;

93. See, e.g., Meeting Consumers' Expectations, *supra* note 83, at 4 (noting that regulations limiting cross-border provision of services such as cold calling may be allowable when passed to protect the recipient of the services).

94. See, e.g., E-Commerce and Financial Services, *supra* note 70, at 13 (noting that harmonization is not currently present in the national rules relating services to professionals).

95. Thus, for example, if it were alleged that the UK was maintaining conduct of business rules which contravene Article 3 of the Directive on Electronic Commerce, *supra* note 5, a financial services company established in England could bring an action before the High Court for a declaration that these rules were invalid. The High Court would have the power to refer the interpretation of Article 3 to the European Court of Justice under Article 234 of the Treaty establishing the European Community (Consolidated Version, O.J. C 340, 10 November 1997, 173–308).

- (g) imposition of standard clauses or minimum insurance conditions;
- (h) clauses imposing mandatory levels of excess in insurance policies;
- (i) compulsory stipulation of a surrender value in life assurance policies;
- (j) prohibition of cold calling;
- (k) arrangements introduced by the host Member State for charging indirect taxes on insurance premiums for policies concluded under the freedom to provide services: appointment of a tax representative of the insurer.⁹⁶

3. *A De Facto Partial Ban on Cross-Border Supplies.* The single market is comparatively complete for banking services, and there are now several online banks serving multiple jurisdictions from a single country of licensing and regulation.⁹⁷ This is not, however, true for investment services and insurance.⁹⁸ The effect of the general good derogations examined in Part III.C.1 *supra* is to produce a de facto ban on cross-border supply of investment products, insurance products, and brokerage services.⁹⁹ In practice, an online supplier of financial services is required to comply with the different, and, in many cases, incompatible conduct of business rules of all fifteen member states.¹⁰⁰

For this reason, the single market in financial services is a theoretical construct only. Work has been under way for some years to complete the market, concentrating in particular on legislation to harmonize the distance selling of financial services.¹⁰¹ So far as distance selling by online means is

96. Commission Interpretative Communication for Freedom to Provide Services and the General Good in the Insurance Sector, 2000 O.J. (C 43) 20.

97. See, e.g., First-E, at <http://www.firste.com> (last visited Aug. 11, 2001). An Internet bank trademark used by the French Bank "Banque d'Escompte," First-E bank serves customers in England, Wales, Germany, Spain, and France. *Id.*

98. See E-Commerce and Financial Services, *supra* note 70, at 11–13 (indicating that further harmonization is needed for the rules governing the insurance sector, investment services, and the marketing of financial services).

99. Communication of the Commission, Financial Services: Implementing the Framework for Financial Markets: Action Plan, COM (99)232 final at 9–10 (noting that the application of member state national rules impedes the ability of suppliers from providing cross-border services).

100. See E-Commerce and Financial Services, *supra* note 70, part 3 (recognising that diverse conduct of business rules among the European Nations may impede cross-border activities).

101. Amended Proposal on Distance Marketing, *supra* note 56, at art. 1.

concerned, however, this initiative has been overtaken by the Electronic Commerce Directive.

IV. THE ELECTRONIC COMMERCE DIRECTIVE—A NEW DAWN
FOR ONLINE FINANCIAL SERVICES?

The Electronic Commerce Directive (“Directive”) has to be implemented into the laws of the EU member states by January 17, 2002.¹⁰² Because the EU legislature, as a parallel exercise, has been discussing a proposed law on the distance selling of financial services for some years, it was initially thought that the Directive would have little impact on financial services.¹⁰³ However, further analysis reveals that the effect of the Directive—a non sector-specific liberalization of cross-border electronic services—will be to pre-empt that proposed legislation where activities are carried out online.¹⁰⁴

A. *The Scope of the Directive*

The Directive applies to “information society services,” defined in Article 2(a) by reference to prior legislation as: “any service normally provided for remuneration, at a distance, by electronic means and at the individual request of a recipient of services.”¹⁰⁵

It is immediately apparent that all forms of online financial services fall within this definition.

The following are some limitations on the scope of the Directive:

??Matters to which the Directive does not apply at all,¹⁰⁶
none of which restrict financial services providers; and

102. Directive on Electronic Commerce, *supra* note 5, at art. 21.

103. See, e.g., Amended Proposal on Distance Marketing, *supra* note 56.

104. See E-Commerce and Financial Services, *supra* note 70, at 6 (indicating the E-Commerce Directive applies to all “online” services, even aspects of sector specific activities conducted “online” and regulated by other directives).

105. European Parliament and Council Directive 98/48/EC of 20 July 1998 Amending Directive 98/34/EC Laying Down a Procedure for the Provision of Information in the Field of Technical Standards and Regulations, art. 1(2), 1998 O.J. (L 217) 18.

106. As set out in art. 1(5), the Directive does not apply to:

- (a) the field of taxation;
- (b) questions relating to information society services covered by Directives 95/46/EC [data protection] and 97/66/EC [telecommunications privacy];
- (c) questions relating to agreements or practices governed by cartel law;
- (d) the following activities of information society services:
 - the activities of notaries or equivalent professions to the extent that they involve a direct and specific connection with the exercise of public authority,
 - the representation of a client and defence of his interests before the courts,

??Activities to which the country of origin rules set out in Articles 3(1) and (2) do not apply,¹⁰⁷ which are set out in the Annex to the Directive. A number of these are relevant to financial services providers, primarily the following:

- (i) the advertising of collective investment schemes;¹⁰⁸
- (ii) “the taking up and the carrying out of insurance business,” both life and non-life, which are the subject of a separate harmonization regime.¹⁰⁹ However, the activities of insurance intermediaries are not excluded from the scope of the Directive;¹¹⁰
- (iii) choice of law clauses, regulated under the Brussels Regulation,¹¹¹ which will normally prevent a clause disapplying a consumer’s home country law from being effective;¹¹² and
- (iv) “contractual obligations concerning consumer contracts.” The consumer protection aspects of this are covered by consumer protection laws such as the Directive on Unfair Terms in Consumer Contracts,¹¹³ but there may be some aspects of national conduct of business rules which fall under this heading, as would such matters as national language laws rendering consumer contracts unenforceable if they are in a foreign language.¹¹⁴

— gambling activities which involve wagering a stake with monetary value in games of chance, including lotteries and betting transactions.

Directive on Electronic Commerce, *supra* note 5, art. 1(5).

107. *Id.* at art. 3(3).

108. E-Commerce and Financial Services, *supra* note 70, at 8 (citation omitted).

109. *Id.* (citation omitted).

110. *Id.* at n.12.

111. Council Regulation 44/2001 of 22 December 2000 on Jurisdiction and the Recognition and Enforcement of Judgments in Civil and Commercial Matters, 2000 O.J. (L 012) 1–23.

112. E-Commerce and Financial Services, *supra* note 70, at 8, 15.

113. Council Directive 93/13/EEC of 5 April 1993 on Unfair Terms in Consumer Contracts, 1993 O.J. (L 095) 29.

114. Most notably, the language laws of France and Portugal may fall under this heading, but note that it is also possible to interpret general laws such as the Directive on Unfair Terms in Consumer Contracts to render unfavorable clauses void if they are not in the consumer’s own language. This should not be an issue in practice, as any financial services business which is serious about targeting the European market will do so via the languages of its potential customers. *Id.*

In spite of these limitations, it is clear that the Directive will substantially increase the freedom of the financial services sector to establish in one EU state and supply cross-border to the others.

B. New Freedoms Under the Directive

The new freedoms to provide information society services cross-border are, so far as financial services are concerned, very simple. The provider is obliged only to comply with the licensing and other regulatory requirements of its “home” country, that is, the member state where it has a permanent establishment.¹¹⁵ The “host” or customer’s country may not also seek to impose its own regulatory requirements unless these can be justified under the new regime for general good derogations.¹¹⁶

The general principle is set out very clearly in Recital 22 of the Directive:

Information society services should be supervised at the source of the activity, in order to ensure an effective protection of public interest objectives; to that end, it is necessary to ensure that the competent authority provides such protection not only for the citizens of its own country but for all Community citizens; in order to improve mutual trust between Member States, it is essential to state clearly this responsibility on the part of the Member State where the services originate; moreover, in order to effectively guarantee freedom to provide services and legal certainty for suppliers and recipients of services, such information society services should in principle be subject to the law of the Member State in which the service provider is established.¹¹⁷

C. The New Regime for “General Good” Derogations

As we have seen at Part III.C.1 *supra*, under the earlier legislation a member state could impose a regulatory burden on the grounds of the general good without the need for further justification. Thus, the business subject to that burden was forced to challenge the imposition through the courts. Because financial services businesses depend in practice on retaining the good will of their regulators, such a challenge was always unlikely and has, so far, never been mounted.

115. Directive on Electronic Commerce, *supra* note 5, at art. 3(1).

116. *Id.* at arts. 3(2), 3(4).

117. *Id.* at para. 22.

The new regime is quite different. A national regulator that wishes to impose its rules on cross-border suppliers will first need to do the following:

- ?? Justify those rules on one of the grounds set out in the Directive;
- ?? Ask the home country to impose its own measures to address the mischief; and
- ?? Notify the European Commission of its intention.¹¹⁸

Additionally, the Commission will issue an opinion on whether the proposed regulation is compatible with the Directive.¹¹⁹

The Commission communication of February 2001, entitled *E-Commerce and Financial Services* (“Communication”),¹²⁰ suggests strongly that most national conduct of business rules will not pass this procedure:

Over time, Member States have developed diverging contractual rules for the protection of consumers and investors and they play a significant role in determining the shape of the financial service offered. Services accepted as standard in some Member States (for example, an interest bearing current account) may be illegal in others. Such rules, if not essential for the protection of the general good, inhibit the establishment of an internal market in retail financial services Until an adequate level of convergence of national rules is achieved, Member States may, in certain areas, need to continue to apply their domestic rules to consumers and retail investors. However, that application would have to be in conformity with the derogations provided in the e-commerce Directive, in particular the derogation under Article 3.¹²¹

To make matters even more difficult for national regulators who wish to maintain their national rules, the Communication announces a review of national rules relating to retail financial services contracts, with a view to determining which of those rules can validly be retained under the Directive.¹²² The effect of this analysis is likely to be the production of “black” and “white” lists of clauses. The communication states:

This analysis would, of course, not be legally binding nor prejudice any interpretation by the ECJ, nor affect the

118. *Id.* at art. 3(4)(b).

119. *Id.* at art. 3(6).

120. *E-Commerce and Financial Services*, *supra* note 70.

121. *Id.* at 13.

122. *Id.* at 14.

derogations under the electronic commerce Directive. It will, however, be of great assistance in the assessment of the necessity and proportionality of certain measures which may be taken by Member States under Article 3(4–6). It will thus aid Member States in identifying which, if any, of their national consumer and retail investor protection rules they wish to apply to incoming services and to inform service providers accordingly.¹²³

In making this statement, the European Commission is accurate, but rather modest. Previous analyses of this type have been influential in proceedings before the European Court of Justice, and it would be a brave national regulator who would attempt to maintain that a national restriction was justified as being for the general good in light of a black list finding by the Commission.

V. COUNTRY OF ORIGIN REGULATION AS A SOLUTION TO THE CROSS-BORDER REGULATORY PROBLEM?

If the coming into force of the Directive in January 2002 does indeed mark the end of the process of establishing a single market area for financial services in the EU, that process also demonstrates how difficult it is to make the transition from national controls to country of origin regulation. The process began with the First Banking Directive in 1977, and has taken nearly twenty-five years to complete.¹²⁴ It is probable that such speedy progress was only possible because the European Treaty established a legislative process that, following the introduction of majority voting on most Directives, allowed a certain measure of coercion to speed up the passage of legislation.¹²⁵ It would not be unreasonable to conclude that extending the country of origin regulatory principle for financial services to a wider group of jurisdictions, most notably the United States and Japan as the other largest financial services markets, might take even longer.

However, where new regulated sectors of online commerce come into existence, dealing with the cross-border regulatory

123. *Id.*

124. First Council Directive 77/780/EEC of 12 December 1977 on the Coordination of the Laws, Regulations and Administrative Provisions Relating to the Taking Up and Pursuit of the Business of Credit Institutions, 1977 O.J. (L 322) 30 (introducing the goal of uniform requirements for credit institutions throughout the Community; however, not restricting national laws from determining the requirements under which credit institutions would operate).

125. See Treaty Establishing the European Community, Nov. 10, 1997, arts. 192, 249, 252, O.J. (C 340) 173 (allowing the European Parliament, the Council, and the Commission to make regulations and issue directives by majority votes of the members).

problem through country of origin regulation may be a sensible option from the outset. This appears to be happening already with respect to digital identity certification—a fundamental element of the Public Key Infrastructure for digital signatures.¹²⁶

The developing global infrastructure for electronic signatures demonstrates the following two main legislative approaches to the validation of electronic signatures over the Internet:¹²⁷

??Some laws define validity solely in terms of the functions to be achieved by an electronic signature method—primarily evidential functions relating to identity, attribution, and non-repudiation.¹²⁸

??Other laws define validity by reference to the use of digital identity certificates within the electronic signature method,¹²⁹ or grant greater legal weight to such forms of electronic signature.¹³⁰ These laws may be technology-neutral, in the sense that they do not prescribe a particular technical standard that must be adopted but merely describe the requirements that a certificate and its issuing Certification Authority must meet.¹³¹ Some of the earliest laws mandated the use of particular technical standards¹³² but this is now recognized as too restrictive an approach.

126. See REED, *supra* note 10, at 131–36 (reviewing the various approaches to accreditation schemes for Certification Authorities and noting that most schemes allow recognition of foreign Certification Authorities based on mutual recognition of accreditation schemes).

127. Chris Reed, *Legally Binding Electronic Documents: Digital Signatures and Authentication*, 35 INT'L LAW. 89, 99–100 (2001).

128. *Id.* at 99. See also, e.g., Electronic Signatures in Global and National Commerce Act §§ 101(a), 106(5), 15 U.S.C. §§ 7001(a), 7006(5) (2000); European Parliament and Council Directive 1999/93/EC of 13 December 1999 on a Community Framework for Electronic Signatures, art. 5(2), 2000 O.J. (L 013) 12 [hereinafter Community Framework].

129. Reed, *supra* note 127, at 100. See also, e.g., Electronic Transactions Act, 1998, c. 88, § 20 (Sing.), available at <http://www.lawnet.com.sg/freeaccess/ETA-Details.html>.

130. See, e.g., Community Framework, *supra* note 128, at art. 5(1) (describing the legal effect and validity of digital signatures).

131. Reed, *supra* note 127, at 100. See also Community Framework, *supra* note 128, at Annexes I, II (outlining the qualification requirements for certificates and certification providers).

132. See, e.g., Utah Digital Signature Rules, UTAH ADMIN. CODE R154-10-301(4)(a) (2001) (specifying a default standard form for certificates); Gesetz zur digitalen Signatur (Signaturgesetz), v. dd.mm.1997 (BGBl. I 1870 § 14(4)) (requiring, under German law, that current engineering standards be used in testing technical components); Signaturverordnung, v. dd.mm.1997 (BGBl. I 1872 § 18) (establishing, in this German ordinance, procedures for updating and replacing digital signatures).

Those jurisdictions that have taken the second approach have done so for very much the same reasons that the financial services sector is regulated. The expectation is that digital signature technology will become the major enabling technology for online transactions, which means that persons relying on digital identity certificates will need to trust and have confidence in the issuing Certification Authority.¹³³ To ensure this trust and confidence, accreditation schemes will be set up and Certification Authorities will be audited to ensure that they are abiding by the accreditation scheme's rules.¹³⁴ It is noteworthy that the requirements under the EU Electronic Signature Directive,¹³⁵ with which a certification authority must comply if its certificates are to confer the higher level of legal validity on digital signatures, are remarkably similar to those commonly imposed for licensing a bank or financial services institution.¹³⁶

Furthermore, these jurisdictions have recognized that digital identity certificates "need to work for cross-border transactions, which means that an ID Certificate issued in, say, Singapore, needs to be recognized for legal purposes in the UK (and vice versa)."¹³⁷ A Certification Authority will find it unrealistically burdensome to become accredited in each jurisdiction where certificate holders might wish to use electronic signatures based on its certificates; thus, these laws make provision for mutual recognition of foreign accreditation schemes.¹³⁸ The result is that certificates emanating from a Certification Authority accredited under such a scheme will be given equivalent legal effect to

133. Reed, *supra* note 127, at 106 (discussing trends in the use of electronic signatures and the reasons for the trend toward forming accreditation schemes for certifying electronic signatures).

134. REED, *supra* note 10, at 131, 136 (noting the emerging trend of establishing accreditation schemes and using monitoring to verify compliance with the required standards).

135. Community Framework, *supra* note 128, at Annex II. In summary, the requirements are that the certification authority should: operate a secure, efficient, and properly run business; take appropriate steps to identify signatories to whom a certificate is issued; employ suitably qualified personnel and use trustworthy computer systems and products; take measures against forgery and preserve the confidentiality of signature keys; have sufficient financial resources; maintain proper records; not store the signatory's signature-creation data; provide proper information about the terms and conditions on which certificates are issued; and use trustworthy systems to store certificates. *Id.* at 19.

136. Reed, *supra* note 127, at 104 n.69.

137. *Id.* at 106.

138. *Id.* at 101-02 (indicating that some countries' regulations have provisions for accepting electronic signatures that do not meet those countries' own certification requirements).

certificates from a locally accredited issuer.¹³⁹ Thus the Singapore Electronic Transactions Act 1998 section 20 provides:

When any portion of an electronic record is signed with a digital signature, the digital signature shall be treated as a secure electronic signature with respect to such portion of the record, if:

a. the digital signature was created during the operational period of a valid certificate and is verified by reference to the public key listed in such certificate; and

b. the certificate is considered trustworthy, in that it is an accurate binding of a public key to a person's identity because . . .

ii. the certificate was issued by a certification authority outside Singapore recognized for this purpose by the Controller pursuant to regulations made under section 43.¹⁴⁰

Similarly, the Electronic Signatures Directive article 7(1) provides:

Member States shall ensure that certificates which are issued as qualified certificates to the public by a certification-service-provider established in a third country are recognised as legally equivalent to certificates issued by a certification-service-provider established within the Community if . . .

(c) the certificate or the certification-service-provider is recognized under a bilateral or multilateral agreement between the Community and third countries or international organizations.¹⁴¹

Article 7(2) gives the European Commission powers to make proposals for achieving the "effective implementation of standards and international agreements," and to propose the "negotiation of bilateral and multilateral agreements with third countries and international organizations."¹⁴²

Such mutual recognition will not take place on an individual basis, but by recognizing the appropriateness of the requirements and supervision in the recognized jurisdiction. Although it is impracticable for a body such as the UK "tScheme"¹⁴³ "to accredit

139. *Id.* at 103.

140. Electronic Transactions Act, 1998, c. 88, § 20 (Sing.), available at <http://www.lawnet.com.sg/freeaccess/ETA-Details.htm> (last visited Oct. 3, 2001).

141. Community Framework, *supra* note 128, at art. 7(1).

142. *Id.* at art. 7(2).

143. See tScheme, at <http://www.tscheme.org/about/index.html> (last visited Aug. 12,

every Singaporean Certification Authority, it is perfectly feasible to recognize Singapore's single accreditation *scheme*, and thus provide legal recognition in the UK for all Singaporean Certification Authorities accredited thereafter."¹⁴⁴

What is developing, therefore, is a system of country of origin regulation for Certification Authorities.¹⁴⁵ Unlike the EU single market in financial services, this system is growing organically, driven by the cross-border nature of electronic signature services rather than by a need to create a free market in a particular geographical and political area.¹⁴⁶ If this new global regulatory structure proves successful, it will offer a powerful model for the regulation of other new online services.

VI. CONCLUSIONS

January, 2002 is likely to see a substantial growth in online cross-border financial services between the EU member states, encouraged by the Directive's enhancement of country of origin regulation. Cross-border financial services supplied via more traditional channels, such as mail or telephone, will remain subject to local regulation, but online supplies will be freed from this regulatory burden.

The arbitrage opportunity for a non-EU business, such as a U.S. financial services company, is obvious. By establishing a presence in only one EU member state, which of course will be the state with the most favorable regulatory and business regime, the U.S. company will be able to supply the other fourteen states free of most of the current restrictions.

The longer-term implications of the Electronic Commerce Directive are also of interest globally. It seems likely that there will be a rapid convergence of financial services regulation in Europe as governments and legislators modify their laws to attract incoming business to their countries. This process should identify the essential core of financial services regulation, and

2001). This is likely to take on the role of accreditor of UK Certification Authorities—further details are available at fei.interliant.com. Reed, *supra* note 127, at 106.

144. Reed, *supra* note 127, at 106 (emphasis added).

145. *Id.* Even where national laws do not make provision for the accreditation of Certification Authorities, e.g., the U.S. Electronic Signatures in Global and National Commerce Act, 15 U.S.C. §§ 7001–7031 (2000), local Certification Authorities can still benefit from the global country of origin system by either applying for accreditation from a body which is recognized cross-border (e.g., an EU-based accreditation body) or by establishing a local, voluntary scheme and seeking cross-border recognition under the global system.

146. See Reed, *supra* note 127, at 105 (noting that the increasing commercial use of the Internet will encourage the development and use of electronic signatures and ID certificates in order to secure Internet transactions).

thus act as a precedent for reform in other countries. How far, and how fast, country of origin regulation of online financial services will spread to other parts of the world, however, remains to be seen.