

WARNING

(Update July 2010)

A number of substantial changes have since been made to the relevant areas of UK and EU law covered in this report and this report cannot be relied on for legal advice purposes with separate independent legal advice having to be undertaken in any individual case.

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OPENCOIN REPORT

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We have been asked to comment on the proposed secure online cash payment system to be set up by Open Co-op LLP (referred to as Opencoin) under the Financial Services and Markets Act 2000 (FSMA) and associated legislation. This report represents our considered academic opinion with regard to the relevant laws, rules and regulations. This does not constitute formal legal advice to Open Co-op or to any associated parties.

1. INTRODUCTION AND SUMMARY

It should be possible to develop a commercially viable software package incorporating appropriate protocols and cryptographic mechanisms that incorporate or secure one or more of the following specific design objectives.

Such a system could create electronic money with the Hub or another central counterparty either relying on a €150 transaction (and €6 million in total) small issuer exemption or exemption for localised systems (with up to 100 participant members) available from the Financial Services Authority (FSA) in London on application.

A separate or parallel decentralised system may be possible if the FSA would grant a collective exemption or users were made responsible for obtaining their own exemptions or otherwise securing compliance either within the UK or abroad.

A separate individual or personal credit system may also be possible using claims backed by an existing registered electronic money issuer (such as a local bank) or unsupported electronic claims although the commercial reliability, value and attractiveness of the later option is unclear.

The final option would be only to develop the relevant software for use by other network operators either within the UK or elsewhere with appropriate warnings being incorporated advising users to obtain relevant exemptions otherwise secure compliance with local laws.

2. OPENCOIN

Open Co-op wishes to establish a secure online cash payment system in the form of Opencoin. Open Co-op have explained that this will initially take the form of an electronic voucher system which will allow members and non-members of Open Co-op to pay desk fees or receive other business services from Open Co-op on a credit system.

Open Co-op LLP had originally been set up in 2004 to provide office and business services for local entrepreneurs in North London as well as to support the activities of other similar co-operatives and social enterprises. An Internet based community has since been established with the address <http://open.coop>. An initial exploratory meeting was held with members of Open Co-op on 22 November 2007.

Various operational models for the Opencoin systems were discussed with initial ideas concerning cryptography and electronic signatures. Opencoin provisionally intended to use a cipher text model based on David Chaum's original 'digicash' or 'E-cash' format. This was easy to use and apply with no intellectual property difficulties expected. This operated on the basis of a two-key model using a secret key for encryption and a public key for decryption. It is understood that David Chaum's software may still be subject to legal protection in certain countries and the availability of the rights on an open source basis in the UK would have to be confirmed separately.

In terms of use, it was explained that the Opencoin system would initially be used for internal 'hub' payments which referred to the Hub office premises that Open Co-op occupied and which were let out to members and other parties on a fee basis in Torrens Street, Angel, London. This would operate in the form of electronic vouchers or tokens that would be purchased by Hub members.

Second level operations would take place where Hub members used electronic vouchers or tokens to make payment for services or goods outside the Hub environment. This would initially only take place with a limited number of local traders and business outlets although this may be extend over time. It was anticipated that the tokens could then be used on a purely external basis for other payment purposes depending upon acceptance and usage at stage three.

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Fourth level usage concerned payments being made between the Angel Hub and other UK and international Hub communities. Opencoin would then be used within these other Hub models and between the Hub communities.

In the event that the Opencoin software was successfully developed, it was also anticipated that a fifth level usage would arise where other operators acquired use of the Opencoin software and ran parallel systems. It was proposed that Opencoin would be made available on an open source product basis using GPL3. Any residual copyrights would be retained by Open Co-op although it was proposed that all software advantage would be made freely available over the Internet.

The following operational points were highlighted:

- (a) The Opencoin system would operate without any central counterparty or central accounting system to the extent that this would be possible from a software design and legal perspective;
- (b) A central counterparty would (at least initially) only be retained to issue the cryptographic keys;
- (c) The system would operate on a distributed network basis with each member being responsible for the management of their own electronic keys;
- (d) The Opencoin software would create the electronic 'coins' which would be stored in supporting electronic 'wallets' retained by each user;
- (e) It was proposed that there would be no legally enforceable right of cash redemption against the key issuer or Open Co-op or the Hub.

The technical and operational implications of the system outlined were discussed. Other models were compared including E-cash (on which the system was based), Mondex, Barclaycoin, Magex Wallet as well as 'Beans', 'Ripplepay.com' and 'Eko'. Reference was also made to the 'QQ' system used in China which it was understood that the authorities were already examining.

One of the provisional issues identified from a legal perspective was the difference between establishing an electronic note or currency system based on promissory notes and banknotes as distinct from an electronic 'bill' system that would involve the transfer of personal claims on the model of a bill of exchange. The historical background and implications of each of the note and bill model have already been discussed with the Open Co-op members.

3. LEGAL ISSUES

A number of provisional legal issues were identified following the initial discussions with the Open Co-op team. These principally related to:

- (a) Whether receiving payment for paper based vouchers or tokens (which was used as an initial design model) would constitute deposit taking and a regulated activity for the purposes of the Financial Services and Markets Act 2000 (FSMA);
- (b) Whether the receipt of payment for electronic vouchers or tokens would constitute deposit taking for the purposes of the FSMA;
- (c) Whether this would be affected by the availability or non-availability of a right of holders to call for cash redemption by the Hub or Open Co-op;
- (d) Whether the issuance of electronic vouchers or tokens would constitute electronic money for the purposes of the EU Electronic Money Directive (EMD);¹
- (e) Whether any exemptions may be available under the EMD or UK implementing rules and regulations;

¹ Directive 2000/46/EC of the European Parliament and of the Council on the taking-up, pursuit of and prudential supervision of the business of electronic money institutions of 18 September 2000.

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- (f) Whether the provision of operating software of itself (which would allow other parties to issue electronic vouchers or tokens) would constitute a regulated activity under the FSMA;
- (g) Whether a parallel paper based or electronic voucher or token system would constitute the issuance of money in breach of the monopoly right of note issuance retained by the Bank of England;
- (h) Whether any separate measures would apply with regard to anti-money laundering or anti-terrorist activity;
- (i) Whether Opencoin would constitute a money transmission service or involve the issuing and administering of means of payment under the European Banking Consolidation Directive (BCD);
- (j) Whether Opencoin would constitute a 'money service business' (MSB) under relevant FSA or HM Revenue & Customs (HMRC) guidance or a 'payment service provider' (PSP) under the EU Payment Regulation;
- (k) Whether the EU E-Commerce Directive would apply and its implications;
- (l) Whether the EU Distance Selling Directive would apply and its implications.

4. FINANCIAL REGULATION

The following comments may be made with regard to the principal legal issues involved.

(a) General Prohibition, Deposits and Deposit Taking

A person may not carry on a regulated activity in the UK (or purport to do so) unless he is an authorised person or an exempt person (under s 19 FSMA). This is referred to as the general prohibition. An activity is a regulated activity for the purposes of the FSMA if it is an activity of a 'specified kind' which is 'carried on by way of business' and (a) relates to an 'investment' or a specified kind or (b) in the case of an activity which is specified, is carried on in relation to property of any kind (s 22(1) FSMA). Specified means by order of the Treasury (s 22(5)) with investment including any asset, right or interest (s 22(4)).

(i) Accepting Deposits

Specified activities and specified investments are set out in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (RAO) as amended.² Specified activities include accepting deposits (regulations 5-9 AA RAO) and specified investments include deposits (reg 74). Accepting deposits is specified if (a) money received by way of deposit is lent to others or (b) any other activity of the person accepting the deposit is financed wholly (or to a material extent) out of the capital of or interest on money received by way of deposits (reg 5(1) RAO). Deposit means a sum of money (other than an excluded sum under regs 9-9a) paid on terms (a) under which it is repaid (with or without interest or premium) either on demand or at a time or in circumstances agreed by or on behalf of the person making the payment and the person receiving it and (b) not referable to the provision of property (other than currency) or services or the giving of securities (reg 5(2)).

Money is paid on terms which are referable to the provision of property or services or the giving of security if and only if (a) it is paid by way of advance or part payment under a contract for sale, hire or other provision of property³ or services and is repayable only in the event that the property or services is or are not in fact sold,

² Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 201/544) as amended by SI 2001/3544, SI 2002/682, SI 2002/1310; the Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) (No. 2) Order 2002, SI 2002/1776; and Financial Services and Markets Act 2000 (Commencement of Mortgage Regulation) (Amendment) Order 2002 SI 2002/1777.

³ Property includes currency of the UK or any other country or territory. Reg 3(1) RAO. Property can be understood to include money and all other property, real or personal, including things in action and other intangible property. S 4(1) Theft Act 1968. Halsbury's Laws of England (2003 Reissue) vol 11(1) para.285. Property refers to a right over a determinate thing, either a tract of land or a chattel' Bryan A Garner, A Dictionary of Modern Legal Usage (OUP Oxford 2 ed 1997) 704 quoting Hohfeld, Wesley N Hohfeld, Fundamental Legal Conceptions (1999 rep 1946) 28-29. Property includes real property and personal property. Property signifies a beneficial right in or to a thing. Property is the highest right a man can have to anything being that right which one has to lands or tenements, goods or chattels which does not depend on another's courtesy. John Burke, Jowitt's Dictionary of English Law (Sweet & Maxwell London 2 ed 1977) 14447. Property has also

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hired or otherwise provided, (b) it is paid by way of security for the performance of a contract or by way of security in respect of loss which may result from the non-performance of the contract or (c) it is paid by way of security for the delivery up or return of any property whether in a particular state of repair or otherwise (art. 5(3)).

(ii) Repaid on Demand or in Circumstances Agreed

The receipt of payment for paper deposits will not constitute a 'deposit' for the purposes of the RAO and FSMA to the extent that the sum involved is not to be repaid at a subsequent time but is to be used for the purchase of services provided by the Hub. Repayment must be understood to refer to repayment of cash⁴ rather than provision of service. No question of interest or premium arises in the present circumstances. Difficulties may nevertheless arise where a pre-agreed right of redemption was provided allowing individuals to cash in the vouchers subsequently. Where a confirmed right of redemption is available, this could be argued to constitute a deposit to the extent that the funds would be repaid 'on demand or at a time or in circumstances agreed' by the parties.

This does not prevent other parties receiving the vouchers from presenting them for encashment. The funds are then not repaid to the original payer with no issue of direct repayment arising. It is also possible for third party traders to exchange vouchers for cash on a discretionary basis. Where the trader was acting on a pre-agreed basis to redeem vouchers for cash, they could be considered to be acting as agent on behalf of the original payee which would then constitute a form of repayment 'in circumstances agreed by or on behalf of' the original parties. Cash redemption should then only be made available at the trader's option. The availability of subsequent repayment from the issuer should not affect this as the trader is still assuming the credit risk and risk of possible default against repayment from the issuer. It should nevertheless be made clear in the relevant documentation that traders do not act as agents on behalf of the issuer and that no legally enforceable right of cash redemption exists against traders.

(iii) Provision of Property or Services

In considering the arrangements discussed with Open Co-op, the issuance of paper vouchers would not constitute a deposit as this would be referable to the provision of property (other than currency) or services (under art. 5(2) (b) RAO). Currency is not separately defined⁵ although this will by implication include sterling or any other foreign currency⁶. It is clearly arguable that this constitutes an 'advance' or 'advance ... payment' for the sale of property in the form of the voucher itself. This could either be understood to mean full (rather than partial) advance payment⁷ or the payment taking place at any time before the delivery of the voucher in exchange for the payment made.

(iv) Finance Activities

To constitute the specified activity of accepting deposits, the issuer also either has to on-lend the money to others or finance its activities either wholly or to a material extent from the funds received. It is understood that the Hub

been referred to as the right to possess, use and enjoy a determinate thing being either a tract of land or a chattel. Bryan A Garner, *Black's Law Dictionary* (Thomson West, St Paul, MN 8 ed 2004) 1252.

⁴ Cash means money or its equivalent including currency, coins, negotiable cheques and balances in bank accounts. *Black's Law Dictionary* (n1) 229. Cash is money or properly ready money of the current coin of the realm including Bank of England notes which are treated as equivalent to coin. *Miller v Race* (1758) 1 Burr 452 quoted in *Jowitt's Dictionary of English Law* (n) 292. [On banking, see generally *The Digest* (Butterworths London 2006 3rd reissue) vol. 3(3); and on money, *The Digest* (2006 3rd reissue) vol. 34(2).]

⁵ Currency means any item (such as coin, government note or banknote) that circulates as a medium of exchange. *Black's Law Dictionary* (n1) 411. Currency also means the medium of exchange circulating in a country, coin and banknotes or other paper money issued by authority and which are continuing passing as and for coin. *Jowitt's Dictionary of English Law* (n2) 531.

⁶ Foreign currency is defined under s 2(6) of the Banking and Financial Dealings Act 1971 as meaning any currency other than sterling and any units of account defined by reference to more than one currency (whether or not including sterling). See also s 6(5)(e) of the Export and Investment Guarantees Act 1991 on special drawing rights and foreign currencies for commitment limit purposes.

⁷ Payment refers to performance of an obligation by the delivery of money or some other valuable thing accepted in partial or full discharge of the obligation. It also includes the money or other valuable thing so delivered in satisfaction of an obligation. *Black's Law Dictionary* (n1) 1165. Payment also refers to the transfer of money from one person (the payer) to another (the payee). Payment in fact is an actual payment from the payer to the payee with payment in law being a transaction equivalent to actual payment. *Jowitt's Dictionary of English Law* (n2) 1337.

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as original issuer will use the funds against its general operating expenses and not on-lend. It is arguable that another activity of the issuer is being financed partially by the funds received although it has to be expected that most payments for services will be paid directly rather than through the virtual system to be set up under Opencoin (reg 5(1)(b)). The Hub will in any case have other direct payments or possible donations, grants or endowments and not be wholly dependent on the use of the voucher scheme to fund its activities.

(v) Carrying on Regulated Activities by Way of Business

Accepting deposits must also be carried out on a day-to-day basis and not only on particular occasions⁸. This 'business requirement' does not alter the previous comments made where the Hub will act as issuer as it may be providing vouchers on a day-to-day basis and not only on particular occasions. This may be relevant where a separate issuer is involved that does not do this on a day-to-day basis

(vi) Exemptions

A number of more general exemptions are made available under the FSMA.⁹ This includes charities insofar as deposits are accepted from another charity (or no interest or premium is payable)¹⁰ or funds received by an industrial and provident society in the form of withdrawable share capital.¹¹

The RAO also contains more specific exemptions from the definition of deposit. This includes payments received by certain persons such as the Bank of England, other authorised persons or national or international banks or financial institutions (reg 90(1)). A sum is also not a deposit if it is immediately exchanged for electronic money (reg 9A RAO).¹² This also includes money paid by a person in the course of carrying on a business consisting wholly or to a significant extent of lending money (regs 6(1)(b) and 90(2) RAO), sums between members of the same corporate group (regs 6(1)(c) and 90(3) RAO) or paid between close relatives or directors or managers (regs 6(1)(d) and 90(4) RAO). Investments of a specified kind include electronic money (reg 74A).¹³

(b) Royal Mint

No question of coinage will arise to the extent that the vouchers are issued in a paper rather than metallic form. Where metallic tokens were involved, the relevant legislation concerning the issuance of coinage in the UK would have to be considered.

(i) Forgery and Counterfeiting

The production and use of documents that look like or purport to be banknotes are separately prohibited under the Forgery and Counterfeiting Act 1981. Specific offences are created in connection with the making, passing, tendering and delivering of counterfeit currency notes or protected coins (ss 14-19 and 2(2) Forgery and Counterfeiting Act 1981 as amended).¹⁴ This should not be relevant to the extent that the vouchers are issued in a

⁸ Financial Services and Markets Act 2000 (Carrying on Regulated Activities by way of Business) Order 2001 SI 2001/1177 art. 2(1)(a) and (b).

⁹ Financial Services and Markets Act 2000 (Exemption) Order 2001 SI 2001/1201 as amended.

¹⁰ Art. 4 and Schedule Part II para.22(a) and (b).

¹¹ Art. 4 and Schedule Part II para.24. The AKO currency scheme operated by the Findhorn Foundation in Forres, Elgin, Scotland was previously considered exempt by the Bank of England on the basis inter alia that it was a registered charity. See also FSMA 2000 (Exemption) Order 2001 Schedule Part IV para.44 Charities.

¹² Inserted by SI 2002/682.

¹³ Inserted by SI 2002/682.

¹⁴ The importation, landing, unloading or exportation of a counterfeit of a currency note or a protected coin is prohibited without Treasury consent (ss 20 and 21). A currency note is any note that has been lawfully issued in England and Wales, Scotland, Northern Ireland, any of the Channel Islands, the Isle of Man or the Republic of Ireland and is or has been customarily used as money in the country where it was issued and is payable on demand or any note that has been lawfully issued in any other country and is customarily used as money in that country (s 27(1)). Protected coin means any coin which is customarily used as money in any country or is specified by order of the Treasury (s 27(1)). This includes sovereign, half-sovereign, Krugerrand and any coin denominated as a fraction of a Krugerrand and Maria-Theresa thaler with the date 1780. Forgery and Counterfeiting (Protected Coins) Order 1981 SI 1981/1505. A note or coin is counterfeit if it is not a currency note or protected coin but resembles a note or coin (whether on one side or both) to such an extent that it is reasonably capable of passing for a currency note or protected coin of that description or if it is a currency note or protected coin which has been so altered that it is reasonably capable of passing for a currency note or protected coin of some other

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paper form with no attempt to replicate existing banknotes. No issue of forgery or counterfeiture should also arise with electronic vouchers or other tokens or claims as the Act appears to be limited in application to paper notes and metallic coinage.¹⁵

(II) Foreign Exchange

Separate difficulties may arise where the issuer is considered to be exchanging foreign exchange and act as a bureau de change requiring registration with HM Revenue & Customs (HMRC). This should not be a problem to the extent that paper vouchers are used with payments only being made in exchange for vouchers rather than other currencies. The fact that the vouchers were purchased in another recognised currency on an occasional basis should not cause any difficulty although this could be confirmed. Whether issuing electronic claims under the Opencoin system should not involve operating a bureau de change or transmitting rather than issuing money for the purposes of the definition of a money service business under the Money Laundering Regulations is considered further below.¹⁶

(c) Deposit Taking and Electronic Vouchers

Where the Hub, Open Co-op or any other central counter party issues electronic vouchers, tokens or coinage in place of paper vouchers, the same definitions of deposit and accepting deposits would apply under the FSMA and RAO. The only difference that would apply from the above is whether the issuing of an electronic claim (voucher, token or coinage) will constitute 'property' for the definition of deposit (under reg 5(2)(b) and (3) of the RAO). It is arguable that this would simply constitute intangible property with the same exemption from the definition of deposit being available where Opencoin operated as a voucher system.

(d) Right of Redemption

The definition of deposit includes a right to repayment either on demand or at a pre-agreed time or circumstance (reg. 5(2) RAO). This may include a right of paper or electronic voucher redemption agreed between the issuer (Open Co-op, the Hub or other central provider) and the original payer ((a) above). This would not, however, apply with regard to other persons receiving the vouchers from presenting them for redemption including third party traders. Third party traders can also pay cash for vouchers received from original purchasers of the voucher or from persons to whom the vouchers had been transferred (above). The documentation should nevertheless record that the original purchaser of vouchers does not have an enforceable and immediate right of redemption as against the original issuer ((a) above).¹⁷ As noted, where electronic money is involved, it is expressly provided that a sum is also not a deposit if it is immediately exchanged for electronic money (reg 9A RAO).

(e) Note Issuance

The Bank of England has the exclusive right to issue notes in England and Wales under s 11 of the Bank Charter Act 1844 (as amended).¹⁸ The Bank may issue notes of such denominations as the Treasury may approve but no others (under s 11 of the Currency and Bank Notes Act 1954¹⁹). Money which constitutes legal tender consists of

description (s 28(1) Forgery and Counterfeiting Act 1981). This will not apply in the present case.

¹⁵ n 14.

¹⁶ This nevertheless depends on 'transmitting' being understood to refer to the movement or transfer of existing claims (including any representation of monetary value) rather than original issuance. HMRC are required to maintain a register of money service operators in such form as considered appropriate under the Money Laundering Regulations 2001 (reg 4(1) and (2)). Commissioners were given additional powers of entry and inspection and access to recorded information under Part III of the Regulations. Sub-sections 6(a)(ii), (iii) and (iv) below.

¹⁷ On redemption of e-money, see sub-section 5(b) and (n 34) below.

¹⁸ Only Bank of England notes are legal tender in England and Wales although notes may be accepted as means of payment. *Halsbury's Laws of England* (n), Money (2005 Reissue) Vol. 32 para.122. On legal money, Money (2005 Reissue) para.103. On bank notes, Banking (2005 Reissue) Vol 3(1) para.106.

¹⁹ *Halsbury's Laws of England* Money (2005 Reissue) Vol.32 para.122 (n2); and Banking (2005 Reissue) vol.31 para.106.

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either coins made and issued by the Crown under the exclusive powers conferred at common law²⁰ or banknotes made and issued by the Bank of England under statutory power.²¹

Money includes banknotes and coinage.²² The meaning of the term depends upon the particular context used.²³ The primary function of money is to service a medium of exchange.²⁴ Money can also be used as a common standard of value, unit of account²⁵ and store of value or purchasing power.²⁶

The Opencoin system should not breach the monopoly rights of the Bank of England to issue sterling notes in the UK to the extent that no paper money is printed. The system will operate on an electronic claim basis as outlined above. This would be considered in a similar manner to the Forgery and Counterfeiting Act 1981. The offences relating to counterfeit coins and notes have already been referred to.²⁷

5. ELECTRONIC MONEY

Electronic vouchers, tokens or coinage may constitute electronic money for the purposes of the FSMA and RAO as amended. Issuing electronic money has been incorporated as a regulated activity under the RAO (regs 9B-9K and 74A).²⁸ This implements the EU Electronic Money Directive (EMD). Electronic money is then not included within the FSMA as such although it is incorporated within the RAO with investments and investment activities being as set out in the RAO (FSMA s 22(5)).

(a) Definition

Electronic money is not defined in the RAO²⁹ but in the EU Electronic Money Directive. Electronic money is defined as monetary value as represented by a claim on the issuer which is:

- (a) stored on an electronic device;³⁰
- (b) issued on receipt of funds of an amount not less in value than the monetary value issued;³¹ and
- (c) accepted as means of payment by undertakings other than the issuer (art. 1(3)(b) EMD).

²⁰ The Chancellor of the Exchequer is the Master of Mint. s 4(1) of the Coinage Act 1971. The Mint had originally been set up in the Tower of London but moved to the Mint on Tower Hill in 1810 and subsequently to Llantrisant, Pontyclun, Mid-Glamorgan. Sir John Craig *The Mint* (1953).

The Crown enjoys the exclusive right of making and issuing money at common law although this right could be granted by franchise or claimed by prescription. *Halsbury's Laws of England*, Money (2005 Reissue) Vol.32 para.103 (n2). The impression or stamping of coins is at the Crown's prerogative with grantees using a stamp provided by the Exchequer. 1B1 Com (14th edn) 277. The denomination or value of coinage is also determined by the Crown in all cases. 1B1 Com (14th edn) 277-278; 2 CoI Nst 577. The prerogative rights to fix the dimensions, designs, denominations and standards of weight and fineness of coins has since been regulated by statute under the Coinage Act 1870, the Coinage Act 1971 and the Currency Acts 1982 and 1983. *Halsbury's Laws of England* (cit). UK currency is denominated in pound sterling and the penny as adjusted following decimalisation on 15 February 1971 as appointed under the Decimal Currency Act 1967. On earlier prerogative rights, Sir C W C Oman, *The Coinage of England* (1931).

²¹ (n 23).

²² On notes, *Wright v Reed* (1790) 3 Term Rep 554; and *Suffel v Bank of England* (1882) 9 QBE 555 and 563 CA per Jessel M R.

²³ *Perrin v Morgan* [1943] AC 399, [1943] 1 All ER 187 HL (where a bequest of 'all moneys of which I die possessed' was held to include all of the net personality but not the realty of the testatrix).

²⁴ *Moss v Hancock* [1899] 2 QB 111 at 116 per Darling J.

²⁵ *Adelaide Electric Supply Co Ltd v Prudential Assurance Co Ltd* [1934] AC 122 at 148 HL per Lord Russell

²⁶ *Banco de Portugal v Waterlo & Sons Ltd* [1932] AC 452 at 508 HL per Lord Macmillan.

²⁷ (n 14).

²⁸ Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2002 SI 2002/682. This is subject to transitional provisions for persons issuing electronic money before the coming into effect of the SI on 27 April 2002

²⁹ A definition is nevertheless incorporated under art. 1 of the Financial Services and Markets Act 2000 (EEA Passport Rights) Regulations 2001 SI 2001/2511. This refers to art 1 of Directive 2000/46/EC.

³⁰ The definition of electronic money requires that the claim is stored on an electronic device. This suggests that the definition only applies with regard to smart card or other device based systems rather than software programmes. Even with a software system, however, the claim would still be stored on the hard drive of the PC or central processor used. Device may then be understood to refer either to a smart card of some form or computer hardware more generally including PCs, desk tops and central processing systems.

³¹ (n 22).

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An electronic money institution is an undertaking or other legal person that issues means of payment in the form of electronic money other than a credit institution.³² Member States are required to prohibit all persons or undertakings that are not credit institutions from carrying on the business of issuing electronic money (art 1(4) EMD).

The activities of electronic money institutions must be restricted to the provision of closely related financial and non-financial services (such as the administering of electronic money by the performance of operational and other ancillary functions related to its issuance) and the issuing and administering of other means of payment excluding the granting of any form of credit.³³ Electronic money institutions can also store data on electronic devices on behalf of other undertakings or public institutions (art 1(5)(a) and (b) EMD). Electronic money institutions must not have any holdings in other undertakings except where those undertakings perform operational or other ancillary functions related to electronic money issued or distributed by the institution concerned.

The electronic coinage proposed to be issued under the Opencoin system will constitute electronic money for the purposes of the EMD. Every issuer of such electronic coinage will then be an electronic money institution for the purposes of the EU EMD and UK RAO. The EMD re-applies the core provisions of the Banking Directive to electronic money institutions (art 2). A number of other conditions are then imposed with regard to redemption,³⁴ initial capital, limitations on investments, verification and sound and prudent operation (arts 3-7).

It may be possible to avoid the application of the definition of electronic money where electronic claims are issued without receipt of funds of an equivalent value (as provided for under sub-para 2 of the definition of electronic money).³⁵ The effect would be to create a transferable electronic claim rather than note system. This would parallel the historical use of bills of exchange rather than banknotes where the value of the bill depended on the creditworthiness of the drawee and each signatory. This would generally only work where all acceptors trusted the creditworthiness of each other party within the network.³⁶

(b) Available Exemptions

The RAO contains specific exemptions from the definition of issuing electronic money as a regulated activity for certified small issuers (reg 9C RAO). This generally applies where electronic money is not issued in excess of a value of €150 with the total liabilities of the issuer not exceeding €5m generally or €6m in all cases (reg 9C(4) (a) and (b) RAO). The maximum limit may be increased to £10m where the electronic money is used within a corporate group (reg 9C(5)) or where the electronic money is only used as a means of payment within a limited scheme of not more than 100 persons (reg 9C(6)(a) and (b)).³⁷

³² As defined in art 1 of Directive 2000/12/EC of the European Parliament and the Council relating to the taking up and pursuit of the business of credit institutions of 20 March 2000 as replaced by Directive EC/46/EEC (the recast Banking Consolidation Directive).

³³ An electronic money institution is prohibited from issuing credit under the EU EMD and UK implementing measures. For comment, FSA, *The Regulation of Electronic Money Issuers* (December 2001) Consultation Paper 117 pp 4 and para 6.51.

³⁴ The EU EMD and UK implementing measures expressly require that e-money must be subject to an express right of redemption or exchange. This would not, however, apply where a small issuer exemption was available. Sub-section 5(b) below. This would not constitute deposit taking as a sum is not a deposit if it is immediately exchanged for electronic money (reg 9A RAO) (n 12) above.

³⁵ The definition also requires that the claim is issued 'on receipt of funds of an amount not less in value than the monetary value issue'. This requires that there is a clear exchange of other funds for the new electronic claim. This would then not apply where one person directed another to make payment to the issuer under a separate obligation to the issuer. The issuer would receive property or services rather than funds directly which would not fall within the definition of electronic money contained in art 1(3)(b)(ii) of the Electronic Money Directive. The effect would be to create a form of 'electronic bill' (or bill of exchange) with existing payment or credit obligations being transferred in satisfaction and discharge of other obligations. The terms and conditions of operation would nevertheless have to specify that credits could not be transferred in return for cash payments directly as this would then constitute the issuance of electronic money.

³⁶ See, for example, Ryan Fugger, 'Money as a IOUs in a Social Trust Network and a Proposal for a Secure, Private, Decentralised Digital Currency Protocol' available <http://open.coop/background+docs>. Care would also have to be taken to ensure that no element of credit was involved as this may raise separate consumer credit issues. Electronic money institutions are also expressly prohibited from issuing credit (n 33) above.

³⁷ The persons must only accept the electronic money at locations within the same premises or limited to the local area or those persons must have a close financial or business relationship such as a common marketing or distribution scheme. Locations are deemed to be within the same premises or limited local area where they are within a shopping centre, airport, railway station, bus station or campus of a university, polytechnic college, school or similar education establishment

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Such small issuers are exempt where they hold a certificate issued by the FSA under Article 9c RAO (reg 9C(1)). Applications may be made by a body corporate or partnership which has its head office in the UK (reg 9C(2)). Applications are treated in an equivalent manner as applications for Part IV permissions under the FSMA (reg. 9D RAO).³⁸ The RAO contains additional provision with regard to revocation by the FSA or on request (reg 9E and F), obtaining information (reg 9G) and records (reg 9K). Electronic money issuers may be prohibited from issuing electronic money at a discount (reg 9H) with an offence being created for making false claims to be a certified person to issue electronic money (reg 9I). Persons receiving electronic money are excluded from the compensation scheme maintained under Part XV of the FSMA (reg 9J).

Where the Hub, Open Co-op or any other central counterparty issues electronic money, they will have to obtain a small issuers certificate from the FSA. Further information and application forms can be obtained as required. Where, however, it is proposed by the Opencoin system operates on a distributed network basis with all users issuing their own coinage, each participant may constitute a separate electronic money issuer and require an appropriate certificate. The costs and obligations of this will have to be considered. Where the central software operator only issues keys as part of the system's cryptography, this should not constitute issuing electronic money although the final operational details would have to be confirmed. It would probably be more efficient and operationally simpler to have the central software party registered as an exempt small electronic money issuer to avoid the need for separate exemptions being applied for by each user. This would again have to be taken into account in designing the necessary protocols and software.

Despite the terms of the first small issuer exemption conditions, it is understood that the FSA has interpreted this to cover all forms of e-money whether issued in the form of an electronic device (smart card) or software program facility. A number of exemption certificates have apparently been issued for programme rather than device based operators. The principal Opencoin operator would then be able to apply for an appropriate exemption. The only restriction would then be that total assets did not exceed €6m.

Where it was decided to proceed through the separate issuance of electronic coinage by each system's user, more difficulties would arise in that each would have to obtain a separate certificate. It may nevertheless still be possible to make a single application to the FSA which would provide for a single collective certificate or number of parallel certificates to be issued to each user within an identified e-money programme. This is not provided for under the current regulations and may not have been attempted previously although it may be possible at the FSA's discretion. The effect is simply to issue a number of parallel certificates *ab inito* under a common issuance framework. In the event that this was refused, each user would have to apply for a separate exemption certificate unless they were already separately exempt (such as under the local community or business network exemption) or otherwise authorised or not covered (such as being outside the jurisdiction).

(c) Software Provision

Neither Open Co-op, the Hub nor central electronic key provider should be issuing electronic money to the extent that they only make available the relevant software. This is will not constitute a regulated activity and be prohibited under FSMA either to the extent that it constitutes deposit taking business or issuing electronic money. The person using the software will be issuing money and either have to be authorised or exempt as outlined above. An appropriate warning to that effect could be incorporated in any sales contract or supporting sales or user material.

6. MONEY LAUNDERING AND ANTI-TERRORIST ACTIVITY

The EU Money Laundering Directives apply with regard to credit institutions³⁹ as defined in the Banking Consolidation Directive 2000⁴⁰ as reissued and recast in 2006.⁴¹ The relevant regulatory obligations are imposed

or an area that does not exceed 4 sq. km. (reg 9c(7)). Persons are not to be treated as having a close financial or business relationship only because they participate in arrangements for the acceptance of electronic money (reg 9c(8)).

³⁸ This specifically includes ss 51(1)(b) and (3)-(6), 52 (except s 52(6) (8) and 9(a) and (b)) and s55(1).

³⁹ Council Directive 91/308/EEC on the prevention of the use of the financial system for the purpose of money laundering of 10 June 1991 (First Money Laundering Directive) as amended by European Parliament and Council Directive 2001/97/EC of 4 December 2001 amending Council Directive 91/308/EEC on the prevention of the use of the financial system for the purpose of money laundering (Second Money Laundering Directive). These provisions have since been amended and reissued under the Third Money Laundering Directive.

⁴⁰ As amended by Directive 200/28/EC of the European Parliament and Council.

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under the Money Laundering Regulations 2007⁴² which implement the EU Third Money Laundering Directive⁴³ in the UK. All persons are also subject to the penalties imposed under the anti-terrorist legislation in the UK.

(a) Money Laundering

The Money Laundering Regulations 2007 were made on 24 July 2007 and came into effect on 15 December 2007. These restate many of the earlier provisions contained in 2003 Money Laundering Regulations with a number of extensions. The Government has adopted a 'risk based' approach to anti-money laundering controls following FSA policy with implementation being stated to be guided by the principles of effectiveness, proportionality and engagement. The Government has also taken the opportunity to implement the revised Financial Action task Force (FATF) 40 Recommendations on anti-money laundering in the UK.

The 2007 Regulations apply to relevant persons which include credit institutions and financial institutions as defined under the EU Banking Consolidation Directive subject to specified exemptions.⁴⁴ A number of exemptions are provided for under Reg. 4. These include the main exemptions provided under the FSMA 2000 (Exemption) Order 2001 Schedule.⁴⁵ The Regulations also cover exempt persons engaging in financial activity on an occasional or very limited basis as specified in para.1 of Schedule 2.⁴⁶ While some of the exemptions may apply to Open Coin, para.1 of Schedule 2 specifies that all conditions must be satisfied. This would, for example, exclude credit institutions (para.1(f) and Reg. 3(2)(a)).⁴⁷

(i) Credit Institutions

The Regulations apply to a credit institution as defined under the 2006 recast Banking Consolidation Directive (reg 3(2)(a) of the MLR 2007),⁴⁸ The definition nevertheless only applies to credit institutions listed in para 4(1) (a) of the 2006 Directive which refers to accepting deposits and granting credit on own account (essentially banking) and not to para 4(1)(b) which includes electronic money issuers. Even where Even Co-op or its central counterparty was an electronic money issuer, this would not of itself bring it within the scope of the definition of a credit institution under 2007 Money Laundering Regulations although it may still constitute a financial institution.⁴⁹

(ii) Financial Institutions

⁴¹ Directive of the European Parliament and the Council relating to the taking up and pursuit of the business of credit institutions as recast.

⁴² SI 2007/2157.

⁴³ HM Treasury, 'Implementing the Third Money Laundering Directive: A Consultation Document' (July 2006). See also HM Treasury, 'Money Laundering Regulations 2007: Regulatory Impact Assessment' (July 2007).

⁴⁴ MLR 2000 Regs 3(1) and 4.

⁴⁵ These include the main institutional and developmental banks and international financial institutions as well as specific deposit taking exemptions (municipal banks, visiting forces, National Savings Bank, local authorities, industry and provident society, credit union or student loans company) as well as tourists and investment boards, and enterprise schemes, employee share schemes and electricity industry shares, gas industry exemptions, trade unions and employer' associations, charities, schemes established under the Trustee Investments Act 1961, former members of Lloyd's, local authorities, social housing and other specific electricity exemptions. SI 2001/1201 as amended.

⁴⁶ These apply where: (a) the person's total annual turnover in respect of the financial activity does not exceed £64,000; (b) the financial activity is limited in relation to any customer to no more than one transaction exceeding €1,000 (whether the transaction is carried out in a single operation or a series of operations which appear to be linked); (c) the financial activity does not exceed 5% of the person's total annual turnover; (d) the financial activity is ancillary and directly related to the person's main activity; (e) the financial activity is not the transmission or remittance of money or any representation of monetary value (by any means); (f) the person's main activity is not that of a person falling within Reg 1(a), 2(f) or (h) (which include inter alia credit institutions, financial institutions and casinos); (g) the financial activity is provided only to customers of the person's main activity and is not offered to the public. All these conditions have to be satisfied failing which either the FSA or HMRC have to be notified.

⁴⁷ Opencoin may also be considered to involve the 'transmission or remittance' of money or any representation of monetary value. It could be argued that the creation or original issuance does not amount to transmission or remittance although the other conditions will still not be satisfied.

⁴⁸ Reg 3(2)(a) refers to 'a credit institution as defined in Article 4(1)(a) of the Banking Consolidation Directive which is defined under Reg 2(1) as Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions. This is the recast Directive following implementation of Basel II and the EU Capital Requirements Directive (CRD) in the UK.

⁴⁹ Sub-section 6(a)(ii).

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The scope of responsibility of the FSA for money laundering is nevertheless extended to apply to ‘financial institutions’ which provide any of the other activities listed within Annex I to the Banking Consolidation Directive (apart from acting as a credit institution or a bank)⁵⁰ even when these do not require formal authorisation or permission under FSMA. This includes the provision of money transmission services (essentially acting as a ‘money service business’ (MSB)) or issuing and administering means of payment (including credit cards, travellers’ cheques and bankers’ drafts).⁵¹

While the definition of a credit institution under the MLR 2007 would not then include an e-money issuer directly, the definition of a financial institution will include a provider of money transmission services or other entity issuing and administering means of payment. Money is not defined separately in the MLR.⁵² It is therefore unclear whether it includes only paper money or electronic money. Money transmission services are defined in the FSA glossary of terms attached to the MLR 2007 as the activity of transmitting customers’ money (or representations of monetary value) according to customer instructions.⁵³ This activity must nevertheless be carried on by way of business which will be stated, in particular, to involve the charging of a fee. This will then not apply to the provision of a non-profit making service either by a central cryptographic key provider or any central counter party within the Opencoin system.⁵⁴

The reference to issuing and administering means of payment does not appear to be otherwise defined.⁵⁵ Reference is made by way of example to credit cards, travellers’ cheques and bankers’ drafts, all of which are used to make payment by individuals or other account holders. While money and e-money can be used to make payment, it is arguable that it does not constitute a means of payment by itself. The point is nevertheless unclear. In practice, it is also likely that the activity must again be carried on by way of business for the relevant definition to apply although this is unclear at this time.

(iii) Money Service Business

Providing a money transmission service is considered to involve acting as a ‘money service business’ (MSB). An MSB is defined in Regulation 2(1) of the 2007 Money Laundering Regulations as an undertaking which ‘by way of business’ operates a currency exchange office, transmits money (or any representations of monetary value) by any means or cashes cheques which are made payable to customers. The controls applicable to money service businesses and the application of the Money Laundering Regulations are dealt with in additional guidance notes provided by HM Revenue & Customs.⁵⁶

The earlier HM Treasury consultation paper on MSB noted that the sector principally consists of bureau de change, money transmitters and cheque cashers.⁵⁷ This includes service businesses currently supervised by HM Revenue & Customs (HMRC). Firms providing money transmission services will include non-authorised firms

⁵⁰ The Money Laundering Regulations define a financial institution as any undertaking (including a money service business) when it carries out one or more of the activities listed in points 2-12 and 14 of Annex 1 to the Banking Consolidation Directive other than a credit institution or an undertaking whose only listed activity is trading for own account in one or more of the products listed in point 7 of Annex 1 where the undertaking does not have a customer (Article 3(3)(a)). A number of other types of institutions are also included within the definition of financial institutions including insurance companies, investment service providers, collective investment undertakings, insurance intermediaries, EEA branches, the National Savings Bank and Director of Savings in special cases (Article 3(3)(b)-(h)). The relevant activities referred to in the BCD include lending, financial leasing, money transmission services, issuing and administering means of payment, guarantees and commitments, securities issue participation, corporate advice, money broking, portfolio management and advice, safekeeping and administration of securities and safe custody services. The most relevant items are clearly money transmission services and issuing and administering means of payment which will include credit cards, travellers’ cheques and bankers’ drafts. It is again unclear whether Opencoin only provides for the issuance rather than transmission of services (sub-para (4)). It is also arguably that while it does issue and administer means of payment in the form of electronic money, e-money is not referred to as one of the specific activities covered in sub-para (5).

⁵¹ MLR 2000 Regs 3(3)(a).

⁵² See generally (n 22) above.

⁵³ The glossary states that for the purposes of the FSA’s supervision of Annex 1 financial institutions under the MLR 2007, it is its view that in practice any business undertaking this activity will be a money service business and, if it not an FSA-authorized firm, it will be supervised by HMRC. Businesses will then register with HMRC rather than the FSA.

⁵⁴ Sub-section (v) below.

⁵⁵ (n 16) above.

⁵⁶ HMRC, *Money Laundering Regulations 2007* (Draft v2.2 of 19/11/2007). See also <http://www.hmrc.gov.uk/mlr/msb.htm>; <http://www.hmrc.gov.uk/mlr/mlr8.pdf>; and <http://www.hmrc.gov.uk/mlr/mlr9.pdf>.

⁵⁷ Bureau de change buy and sell foreign exchange to retail and business customers and issue and exchange travellers’ cheques. Currency wholesalers would be included. They may charge a fee and make a profit on the exchange rate.

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providing credit card services, bankers' drafts and travellers' cheques and firms operating payment services such as through mobile telephones or independent cash machines.

It could be argued that Opencoin involves the 'issuance' rather than the 'transmission' of money (or any representation of monetary value).⁵⁸ HMRC nevertheless refer expressly to the transmitting of money or any representation of money including businesses involving small e-money issuers which hold an exemption certificate issued by the FSA. It could still be argued that this will depend on the particular activities carried on by the individual e-money issuer some of which may only provide issuance facilities and others separate transmission services. Care will nevertheless have to be taken in this regard.

(iv) Payment Service Provider

Firms providing payment services are also required to comply with the requirements imposed under the Payments Regulation (Wire Transfers Regulation).⁵⁹ Electronic transfers of funds must be accompanied by certain information including the customer's name and account number. Information must be verified before transfer with firms receiving payments being required to monitor samples to ensure that the payer information is correct. The Regulations came into effect on 1 January 2007 with sanctions being imposed from 15 December 2007. Appropriate guidance is available on the JMLSG website.⁶⁰

The same considerations apply with regard to whether an e-money issuer within the Opencoin system would constitute a payment service provider (PSP) under the Payments Regulation. A PSP is defined as a natural or legal person whose business includes the provision of transfer of funds services under Article 2(5) of the Regulations. The same arguments would then apply as to whether Opencoin only involves the 'issuance' or also 'transmission' of funds by electronic means.⁶¹ It is even less likely that Opencoin could be considered to involve the provision of an independent dedicated service whereby Opencoin Co-op accepted customer solely for transmission purposes. While the point is unclear, the definition of PSP again requires that the transfer of funds is carried on by way of business which would not apply where a non-profit service provider only was involved.

(v) Money Laundering Exemptions and Business Condition

Exemptions are available under the Money Laundering Regulations although these are narrowly drafted and will be applied strictly.⁶² These may nevertheless still be applicable especially in light of the limited non-public nature of the services to be provided by Opencoin and assuming that Opencoin does not constitute a financial business which would apply if it not considered to be by way of business.

The definition of money transmission service and money service business and application of the money laundering requirements are dependent on the activity being carried on by way of business. If the central issuer under the core scheme is only acting either to issue cryptographic keys or otherwise to act as a central counter party on a non-profit basis, no business will be involved. The FSA also notes on its website in connection with the application of the money laundering provisions to money service businesses that to be a MSB or a trust or company service provider, the firm or individual must be undertaking these activities by way of business which in the view of the FSA means charging a fee.⁶³

Money transmitters transfer money from one location to another without physically moving cash. The transfer is usually to an overseas location using a variety of methods including wire transfers, telephone and fax, bank transfers and offsetting liabilities. A fee is charged for the transfer and profit made on currency exchange.

Cheque cashers cash cheques made payable to their customers by third parties. A commission is charged for cashing the cheque and accepting the risk that the third party might not honour the cheque. There are approximately 3,200 MSB principals in the UK operating out of the 32,000 premises, the largest of which are the Post Office Ltd, Moneygram International Ltd and Fexco Money Transfer Ltd which own 60% of the premises concerned. Treasury, *The Regulation of Money Service Businesses: A Consultation* (September 2006).

⁵⁸ (n 16) above.

⁵⁹ Regulation (EC) No. 1781/2006 of the European Parliament and of the Council of 15 November 2006 on information on the payer accompanying transfers of funds.

⁶⁰ <http://www.jmlsg.gov.uk>.

⁶¹ (n 16) above.

⁶² (n 43) above.

⁶³

<http://www.fsa.gov.uk/pages/about/what/financialbaselinecrime/moneybaselinelaundrying/3mld/authorised/faqs/index.shtml>.

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Opencoin or any central issuer within the Opencoin system may then not constitute a money service business provider and require registration at such with the FSA or HMRC or otherwise be subject to the Money Laundering Regulations to the extent that no fees are charged and that this facility is only provided on a non-profit making basis.

(vi) Money Laundering Compliance

The 2007 Money Laundering Regulations impose a number of requirements with regard to customer due diligence, procedures, record keeping and training as well as supervision and registration. Customer due diligence measures require the identification and verification of customers' identities, beneficial ownerships and the purpose and intended nature of business relationships (reg 5). Customer due diligence measures have to be complied on the establishment of a business relationship, the carrying out of an occasional transaction, where money laundering or terrorist financing is suspected or a relevant person doubts the veracity or adequacy of the documents, data or information previously obtained. Where a person cannot conduct customer due diligence, they must not carry out the transaction, establish a business relationship or terminate an existing relationship. They must also consider whether a suspicious activity report should be made under the Proceeds of Crime Act 2002 or the Terrorist Act 2000 (reg 11(1)). Suspicions of money laundering or anti-terrorist financing are to be reported to the Serious Organised Crime Agency (SOCA) (reg 24(2)).

(b) Anti-Terrorism

Anti-terrorism measures are principally set out in the Terrorism Act 2000. Terrorism is defined as the use or threat of action involving serious violence against a person, serious damage to property, endangering a person's life (other than that of the person committing the action), creating a serious risk to the health or safety of the public or a section of the public or which is designed seriously to interfere with or seriously to disrupt an electronic system (s 1(2) TA 2000). Terrorism means the use or threat of such action or where the use or threat is designed to influence the government or to intimidate the public or a section of the public and the use of threat is made for the purpose of advancing a political, religious or ideological cause (s 1(1) TA 2000).

A person commits an offence if he enters into or becomes concerned in an arrangement that facilitates the retention or control by or on behalf of another person of terrorist property by concealment, removal from the jurisdiction, transfer to nominees or in any other way (s 18 TA 2000). It is a defence to show that the person did not know or had no reasonable cause to suspect that the arrangement related to terrorist property (s18(2) TA 2000). A separate offence is created where a person in a regulated sector fails to disclose knowledge or suspicion of an offence under the Terrorism Act as soon as practicable (s 21a TA 2000). The regulated sector corresponds with the scope of the financial sector covered by the FSMA.⁶⁴

Where it still may be claimed that the reporting of suspicious information applies, this would only be relevant to the extent that the issuer of Opencoin had 'reasonable grounds for knowing or suspecting' that another person had committed an offence under ss 15-18 of the Terrorism Act 2000 (s21(a)(2)(b) TA 2000). The issuer in this case would only have reasonable grounds for knowledge or suspicion where it had actual information of participation by terrorists or where electronic claims issued were being used for terrorist purposes. As the system is intended to operate on an anonymous and distributed basis, this condition would generally not be satisfied.

Where an offence has been committed under ss 15-18 of the Terrorist Act 2000, a person is liable on indictment to a term of imprisonment of up to 14 years or a fine or both or to 6 months imprisonment on summary convictions (s 22 TA 2000).

7. ELECTRONIC COMMERCE DIRECTIVE (ECD)

The EU Electronic Commerce Directive applies with regard to 'information society services'.⁶⁵ An information society service constitutes any service normally provided for remuneration at a distance by electronic means and at the individual request of a recipient of services. The service must be provided by electronic means.⁶⁶ This will include the provision of banking services carried out entirely on the Internet.

⁶⁴ Schedule 3A para.1(1)(a) TA 2000.

⁶⁵ Art.1(2) of Directive 98/34 of the Electronic Commerce Directive. See also Directive 98/48 EC of the European Parliament and of the Council of 20 June 1998 Amending Directive 98/34 EC Laying Down a Procedure for the Provision of Information in the Field of Technical Standards and Regulations.

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The E-commerce Directive was implemented in the UK under the Electronic Commerce (EC Directive) Regulations 2002⁶⁷ and the Electronic Commerce Directive (Financial Services and Markets) Regulations 2002.⁶⁸ The first set of General Regulations apply to all e-commerce services with the later Treasury Regulations only applying in the financial area. The General Regulations contain the principal provisions with regard to country of origin, information requirements, commercial communications and the liability of information society service providers. The Treasury Regulations contain more specific principles governing the provision of such services in the financial area. These are implemented under the FSA Handbook and, in particular, under the E-commerce sourcebook (ECO).

The 2002 FSMA Treasury Regulations generally only apply with regard to electronic commerce activities carried on by incoming providers from other EEA States other than the UK. The E-Commerce Directive and FSA ECO create a right for all electronic commerce activity to be carried out throughout the EU on a country of origin basis. The effect of this will be to allow the Opencoin system to be used in other Member States of the EU on compliance with the relevant UK requirements.

The General Regulations impose specific obligations with regard to any form of communication that is designed to promote directly or indirectly the bank's services and any promotional offer by providers of online financial services which constitutes or forms part of an electronic commerce activity. A commercial communication means a communication in any form designed to promote directly or indirectly the goods, services or image of any person pursuing a commercial, industrial or craft activity or exercising a regulated profession (reg 2(1)). This must be clearly identifiable as a commercial communication, identify the person on whose behalf the communication is made, identify any promotional offer (including any discount, premium or gift) and ensure that any conditions that must be met to qualify are easily accessible and presented clearly and unambiguously and identified as such any promotional competition or game and ensure that any conditions for participation are easily accessible and presented clearly and unambiguously (reg 7).

8. DISTANCE MARKETING DIRECTIVE (DMD)

Separate measures apply with regard to banking, credit, payment or other financial services sold over the Internet, mail or telephone. The Distance Marketing Directive was adopted in September 2002 following an earlier proposal in 1998.⁶⁹ This applies with regard to any communication that may be used for the marketing of banking and financial services without the simultaneous physical presence of the supplier and the consumer. The Distance Marketing Directive will only be relevant to the extent that the issue of electronic money in the present case issues financial promotions over the Internet.

The Distance Marketing Directive was implemented in the UK under the Financial Services (Distance Marketing) Regulations 2004.⁷⁰ Consumers receiving services without any prior request are not subject to any obligation to make payment or otherwise (reg 15(1)). The supply of financial services to consumers without any prior request (on an unsolicited basis) is made an offence where the firm includes with the supply of those services a demand for payment or an assertion of a present or prospective right to payment in respect of those services (reg 52(2)).

While the decision to allow unsolicited commercial communications by electronic means was left to Member State discretion, this was subsequently prohibited under Directive 22/58 on Privacy and Electronic Communications.⁷¹ This was implemented in the UK under the Privacy and Electronic Communications (EC

⁶⁶ This requires that the service is initially sent and subsequently received at its destination by means of electronic equipment for the processing (including digital compression) and storage of data and that it is entirely transmitted, conveyed and received by wire, radio, optical means or by other electromagnetic means. Art.1(2) Directive 98/48.

⁶⁷ \SI 2002/2013.

⁶⁸ SI 2002/1775 as amended by the Electronic Commerce Directive (Financial Services and Markets) (Amendment) Regulations 2002 SI 2002/2015.

⁶⁹ European Commission Proposal for a Directive of the European Parliament and of the Council Concerning the Distance Marketing of Consumer Financial Services and Amending Council Directive 90/619/EEC and Directives 97/7/EC and 98/27/EC of 14 October 1998 COM (1998) 468 final. See also FSA, *Implementation of the Distance Marketing Directive: Proposed Rules and Guidance* (September 2003) Consultation Paper 196.

⁷⁰ SI 2004/2095.

⁷¹ Directive 22/58/EC of the European Parliament and of the Council of 12 July 2002 Concerning the Processing of Personal Data and the Protection of Privacy in the Electronic Communications Sector.

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Directive) Regulations 2003.⁷² This provides that a person must not transmit (nor instigate the transmission of) unsolicited communications for the purposes of direct marketing by means of electronic mail unless the recipient of the electronic mail has previously notified sender that he consents for the time being to such communications being sent (reg 22). This will only be relevant to the extent that separate financial promotions are involved.

⁷² SI 2003/2426.

9. FSA CONFIRMATION

Open Co-op are advised to attempt to confirm the application of certain key provisions to the proposed Opencoin with the FSA. We would recommend that the following specific questions were referred to the FSA. A copy of this draft Letter of Advice can be provided.

The main issues to confirm are concerned with:

- (a) A small issuer certificate will be available even though Opencoin will operate on a software rather than electronic card basis although this is almost certain at this time;
- (b) A single certificate can be obtained even though the system will operate on a decentralised basis with the central issuer only providing cryptographic keys;
- (c) If Opencoin is certified as a small issuer and excluded from reg 9(b) of the RAO, will any continuing obligations apply under ELM;
- (d) If a small issuer certificate is issued under reg 9(c) RAO, will this disapply for the FSA's purposes the application of reg 9(a) which excludes sums from being deposits if they are immediately exchanged for electronic money;
- (e) The issuance of electronic claims under Opencoin would not constitute accepting deposits for the FSA's purposes to the extent that this was in exchange for electronic vouchers or claims entitling the holder to receipt of services from the Hub or other defined parties of credit against existing fees as this would be referable to the provision of property or services under art. 5(2)(b) RAO;
- (f) The Money Laundering Regulations 2007 would not apply to the issuer of Opencoin to the extent that the occasional or limited basis exemption provided for under para 1 of Schedule 2 to the Regulations was available;
- (g) The issuance of Opencoin would not constitute a money service business for the purposes of the MLR 2007 to the extent that it only involved the issuance rather than transmission of money;
- (h) The issuance of Opencoin would not constitute a money service business for the purposes of the MLR 2007 to the extent that it was not carried on by way of business;
- (i) The issuance of Opencoin would not constitute a payment service payment provider under the Payments Regulation to the extent that it only involved the issuance rather than transfer of funds under Article 2(5) of the Regulation;
- (j) The issuance of Opencoin would not constitute a payment service provider in any case to the extent that it was not carried on by way of business.
- (k) Electronic money would consequently not fall within the definition of financial institution contained in Reg 3(3)(a) of the Money Laundering Regulations 2007 for the FSA's purposes in light of the conclusions in paragraphs (i)-(l);
- (l) The occasional or limited basis exemption would be available to individual issuers of Opencoin;
- (m) An electronic 'bill' (rather than money) system would not constitute electronic money for the purposes of the FSMA to the extent that there was no exchange of electronic money on receipt of funds of an amount not less in value than the monetary value issued under the EMD.

While the FSA may not respond to all of the questions, they should respond to the relevant issues that relate to their scope of activity. The alternative would simply be to apply for a small issuer e-money exemption (without raising any of the more complex issues that arise at this stage) and prepare a registration form for money laundering purposes although submit that with a covering letter stating that Opencoin does not consider that it applies as it operating on a non-profit basis.

10. CONCLUSIONS

Open Co-op should not experience any difficulties to the extent that it wished only to operate a paper based voucher system. Where this is converted into an electronic format, this should not constitute deposit taking for the purposes of the general prohibition imposed under the FSMA provided that no mandatory right of redemption is offered. The payment may also be considered to be made in return for the property or services.

More significant difficulties arise to the extent that the establishment of an electronic currency system will constitute electronic money under the EU Electronic Money Directive and the UK RAO as amended. While the issue of simple cryptographic keys may not constitute an electronic money issuer as such, all individual issuers could become electronic money institutions within a decentralised system. It may then be preferable to have a single counterparty registered as the electronic money issuer. A small issuer certificate should then be available from the FSA which would otherwise exempt the issuer from full compliance with the FSMA and FSA Handbook of Rules and Guidance. Where a software system is being created (as in the present case), the €150 (€6 million total) or 100 person exemption should be available. The issuer may otherwise have to be registered with the FSA and comply with the FSA's general requirements (imposed under PRIN, SYSC and APER) and the more specific obligations contained in ELM. To the extent that electronic communications are also involved, the issuer will have to comply with the electronic commerce obligations imposed under ECO.

The alternative to establishing an electronic note or coin based system would be to consider an electronic bill or claim system. This may nevertheless still constitute electronic money for the purposes of the Electronic Money Directive and RAO as amended. This may only otherwise be avoided where funds are not issued on receipt of an equivalent value. The effect would be to create a simple electronic credit system although this may create separate legal problems. Whether this would be accepted as a means of payment by other issuers (as provided for under the definition of electronic money) would also then depend on market practice, use and reputation.

Where a bank or other central counterparty added its credit to the electronic claim and this was in return for payment or monetary claim, the claim would then constitute electronic money as defined and be subject to the relevant regulations unless a small issuer exemption was available. One option would be to approach a bank as an authorised credit institution to add its credit under defined circumstances. The credit system would then operate on a non-accepted basis within the Hub or other familiar networks (including intra-Hub and inter-Hub activity). Where additional credit was required, the claims could then be presented for electronic acceptance by a bank with whom an appropriate arrangement would be negotiated. The bank would already be a regulated institution with the FSA and hold relevant permissions to accept deposits and issue electronic money. This could be considered depending upon how the present proposal and software design develop.

No difficulties should arise where Open Co-op only wishes to develop the relevant software for use by other network operators either within the UK or elsewhere although it is advisable that appropriate warnings are incorporated advising any purchasers or users should secure compliance with all relevant UK or other local laws.

The issuer of electronic money may be subject to the revised obligations imposed under the Money Laundering Regulations 2007 to the extent that the activities concerned amount to providing money transmission services and issuing and administering means of payment or either acting as a money service business (MSB) or payment service provider (PSP). Opencoin may nevertheless be able to avoid this to the extent that any central issuer or counterparty is clearly identified as being non-profit making (and with no fees being charged for its services) so that the activity is then not carried on 'by way of business'. Exemptions are also available for persons engaging in financial activity on an occasional or very limited basis.

Even where the Regulations did apply, it may be possible to set up a simple compliance system and benefit from the concessions available where only small limited operations are involved. Opencoin may then not have to comply with all of the additional record keeping and reporting obligations imposed. Opencoin would still have to comply with any more general or direct laws and offences on anti-money laundering and terrorist financing although these apply to everyone and require intent and active involvement.

In light of the importance of the current project and potential technical and commercial advantages and benefits that may arise, it is recommended that Open Co-op confirm the residual issues referred to with the FSA or HMRC in writing. All of the relevant points can be referred to or Opencoin can apply for a small issuer exemption for electronic money purposes and notify that it does not consider that the Money Laundering Regulations are applicable as the relevant financial activities are not being carried on by way of business as discussed above.