

# Electronic payment mechanisms<sup>1</sup>

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This article considers the legal and regulatory issues relating to electronic payment mechanisms other than the usual forms of payment, such as cash, credit cards and debit cards.

## Introduction

For trade to be effective, there must be a viable method of measuring value, and the ability to transfer value, by way of a medium of exchange. Historically, the concept of money has become the most popular means of exchanging worth. The instrument by which money is usually evident is in the form of currency. Currency, in turn, typically takes the form of cash, which is physically manifest as coin and promissory documents representing coin, such as bank notes. However, the methods by which money is transferred are not static, and different types of instrument can effect the transfer of value, including the cheque, credit cards and debit or charge cards.

The use of the internet as a medium for trade has posed a variety of challenges, one of which is the introduction of greater flexibility for exchanging money. Many

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<sup>1</sup> The author wishes to thank Anne Crossfield, barrister, of Barristerweb The Internet Chambers, for her comments on the draft of this article.

organizations selling goods and services on-line use methods of payment that have found acceptance in the physical world, such as credit and debit or charge cards. However, not every item sold at a distance is amenable to being bought and sold using such instruments. There are two main reasons for this. First, goods or services can be valued by the trader at levels that do not permit the economic use of credit cards. By way of example, a publisher may wish to charge a viewer to obtain access to an on-line newspaper for a fixed period of time or for a specific number of articles. In the physical world, cash serves to effect the transfer of money for such a modest exchange, but it is more difficult to embody the exchange of low values of currency in the electronic environment. Second, even where the payment of goods or services by way of a credit card is proportionate, large numbers of people do not have credit cards.

Attempts have been made to provide solutions to resolve this problem. The aim of most payment mechanisms developed for use at a distance is to permit the transfer of money electronically at a reasonable cost, otherwise the solution can be more expensive to implement, and thereby defeat the aim.

### **Electronic payment systems**

Part of the reason for seeking alternative methods of making payment remotely, other than by the use of credit and debit cards, is to make it possible for payment to be made in very small denominations, otherwise known as micro payments. The attractiveness of using a credit card in particular to buy goods and services is manifest, but a credit card cannot be used to buy something that may be charged at a fraction of a pence. Hence the plethora of schemes that have been developed over the past ten years. The commercial payment systems generally fall into two categories for legal purposes, account-based and cash-based. Both methods are based on the evolution of the banking system.<sup>2</sup>

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<sup>2</sup> In relation to this matter, the author is indebted to the excellent discussion by Trystan Tether, "Payment Systems for E-Commerce" in Chris Reed, Ian Walden and Laura Edgar, editors, *Cross-Border Electronic Banking Challenges and Opportunities* (LLP, Second edition, 2000). The legal analysis outlined by Mr Tether is adopted in this text in relation to the various types of electronic money system available.

### *Account-based*

In this instance, the person making the payment (Alice) deposits money or money's worth with a trusted third party. Alice makes a payment to the seller (Bob) by giving instructions to the trusted third party to hold the agreed value of her deposit for the benefit of Bob. Once the trusted third party acknowledges Alice's instruction and agrees to be bound by it, Bob can arrange for the value to be transferred to him physically, or he can leave it with the trusted third party for future use on his own behalf.

### The structure of an account-based system

In outline, the account-based payment system will probably have the following attributes:

- a) Both parties will maintain an account with the operator of the system.
- b) The subscribing buyer (Alice) will provide details of her credit card to the operator of the system, authorizing the operator to debit her credit card to make payments into her account with the operator as necessary.
- c) When Alice buys something from the subscribing seller (Bob), she gives an instruction to the operator of the system to debit her account and credit Bob's account. If Alice does not have sufficient credit to pay for the goods or services, the operator of the system will debit her credit card to ensure there are sufficient funds in her account to settle the payment in full.
- d) When the operator of the system receives instructions from Alice, it can credit and debit the respective accounts of Alice and Bob, and then confirm this to both subscribing parties. Bob can supply the goods or services in the knowledge that he has received payment.

An account-based system can have a number of benefits to an issuer, in that there is a negligible cost of transaction (in theory); the operator of the system is not liable to its subscribers, because the accounts are always in credit, and providing the operator does not provide credit to subscribers, it will not be liable for any connected lender liability (although this will not be effective against credit cards where the credit card issuer, upon the receipt of a complaint from a customer, raises a chargeback against the operator of the system); and on the assumption that no credit is given to

subscribers of the system and the operator is not exposed to connected liability risk, the financial standing of individual subscribers will not be relevant.

Whilst there is great advantage in the possibility of providing for an effective micro payment environment that appears to reduce the risk to all parties, nevertheless the disadvantages may negate many of the advantages:

- a) Both the account-based and cash-based systems (see below) are “closed”, in that only participants in the system can take part. As a result, both consumers and retailers have the option of subscribing to a number of differing schemes. It is highly probable that neither consumers nor retailers will wish to subscribe to more than one scheme. The retailer will not want to incur the expense of belonging to multiple schemes, and it is to be debated whether consumers will want to have money scattered around a number of providers. It is also worth bearing in mind that a subscriber will be required to retain a credit balance in each of the systems to which they subscribe. Subscribers will not be able to obtain ready access to the credit balance, and if they are party to more than one system, the combined figure of deposits could be high enough to discourage being a member of more than one. In addition, where electronic money is stolen, it is not clear whether the innocent party is properly protected.
- b) The operator may find itself involved in dealing with disputes relating to sub-standard goods or goods that have not been delivered. The costs of managing this may increase operating costs to such an extent that the concept is not commercially viable.
- c) The activity of holding money on behalf of a subscribing party could be construed as taking a deposit, in accordance with s22(1) and Schedule 2(4) of the Financial Services and Markets Act 2000. This matter was discussed in the consultation exercise carried out by the Treasury. In the Response to Consultation,<sup>3</sup> the Treasury took the view, at paragraph 10, that account-based schemes do come within the meaning of electronic money.

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<sup>3</sup> HM Treasury, “Implementation of the Electronic Money Directive A Response to Consultation”, March 2002.

- d) The operator is subject to the Money Laundering Regulations 1993 (Statutory Instrument 1993 No 1933) and 2001 (Statutory Instrument 2001 No 3641), the provisions of which negate the assumption that an account-based system can be relatively inexpensive to set up and operate. For this reason, as well as the ability to track payments made electronically, such a system cannot be considered to have the attributes of anonymity.

Any breach in security that enables a thief to steal money or cause money to be transferred without the authority of a subscribing party will undoubtedly fall on the operator.

### *Cash-based*

This example also requires Alice to deposit money or money's worth with a trusted third party. In this case, the trusted third party gives Alice a certificate confirming the value of the deposit. Alice can then make a payment to Bob by transferring the certificate to Bob by whatever method required by the trusted third party.

### The structure of a cash-based system

The basic building blocks of a cash-based system can be described as follows:

- a) The customer (Alice) may be given, or might have to pay for, software or hardware (such as a smart card) or a combination of both software and hardware, which will permit her to obtain and store files that represent electronic money. Alice buys electronic money from the operator of the system, and the files are stored on the computer hard drive or within the chip on the smart card.
- b) Alice can buy electronic money files from the operator of the system and store them on her hard drive or smart card. The operator maintains a float of the money used to purchase electronic money. The size of the float should be sufficient to ensure the total amount of electronic money issued can be redeemed at any one time.
- c) Assume Alice decides to buy goods or services from Bob, who also supports the same electronic money protocol to which Alice subscribes. The two computers (or a computer and a smart card), exchange protocols to establish the authenticity of each, amongst other things. A transfer takes place by which

Alice authorizes the transfer of sufficient electronic money to satisfy the price of the goods or services.

- d) When Bob receives the electronic money, he can then return them to the operator of the system, who in turn will credit Bob with the value of the electronic money transferred from Alice. Alternatively, Bob can decide to use his electronic money in turn to pay for goods or services.

#### A cash-based system – some legal issues

Conceptually, electronic money may involve one of two types of relationship. The transfer between Alice and Bob could be construed as a record of a transaction to debit Alice's account and credit Bob's account. In this analysis, it is arguable that the Electronic Money Directive does not apply, because the process as described is one of taking money on deposit, permitting Alice to use her deposit at a date and time of her choosing. Further consideration should be given to the provisions of the Financial Services and Markets Act 2000. The meaning of deposits is set out in Schedule 2 Part I s22:

‘Rights under any contract under which a sum of money (whether or not denominated in a currency) is paid on terms under which it will be repaid, with or without interest or a premium, and 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.’

If this process is determined to be a certificate of deposit, then a cash-based scheme may be a regulated activity under the terms of Schedule 2 Part I. Alternatively, the transaction could be considered in the same way as a promissory note or a certificate of deposit, both of which are transferable and negotiable instruments.

The relevance of this enquiry relates to the theft of electronic money. If it is determined that the system operator holds the money on account, then where the holder (Alice) of electronic money has her electronic money files stolen, Alice retains the right to the payment she made to the system operator. Further, where another spends the electronic money, the operator of the system will be acting on the instructions of somebody other than Alice. The operator is not entitled to act on the instructions of somebody other than Alice, and will, therefore, be required to bear any loss. However, where the electronic money is a negotiable instrument, then the

operator of the system is required to make a payment in relation to electronic money without liability to Alice, from whom the electronic money was stolen.

The costs of running the system can be minimal if there is no requirement to account for individual transactions, and the float of money can be used by the operator to balance the operating costs. Further, it may not cause the operator of the system to be liable for any connected lender liability, although the provisions of the Direct Financial Services Directive will apply.<sup>4</sup> Once the software is in place, it is possible for the system to be used by anybody, and the structure can, possibly, be used to provide for anonymity by selling disposable cards through shops, newsagents and similar outlets.

As with cash-based electronic money systems, it is conceivable that the disadvantages may be greater than the advantages to both consumers and retailers.

- a) Where the cash-based system is used to buy goods or services, the buyer has to trust the seller to deliver the goods or provide the services. In the event a dispute occurs, as where the goods are not delivered or the quality is in dispute, the buyer (if a consumer) may have a range of rights that can be invoked against the seller, but will be in a difficult position to enforce any rights effectively.
- b) The operator is subject to the regulatory environment, including the provisions of the Money Laundering Regulations 1993 and 2001.<sup>5</sup>
- c) Where there is a breach in security of the operating system, two consequences may follow. First, the subscribing parties may obtain electronic money that is of no value. Second, the operator of the system may find that it redeems counterfeit electronic money, with the consequence that the float is reduced. If

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<sup>4</sup> Directive 2002/65/EC of the European Parliament and of the Council of 23 September 2002 concerning the distance marketing of consumer financial services and amending Council Directive 90/619/EEC and Directives 97/7/EC and 98/27/EC (OJ 9.10.02 L217/16).

<sup>5</sup> See Financial Services Authority Handbook Authorisation Manual, Appendix 3 'Guidance on the scope of the regulated activity of issuing e-money' for further guidance.

an attack is severe, it may undermine the solvency of the operator of the system.

## **Electronic money**

### *Definition*<sup>6</sup>

The Commission Recommendation of 30 July 1997 concerning transactions by electronic payment instruments and in particular the relationship between issuer and holder (Payments Recommendation (97/489/EC) (OJ 02/08/1997 L 208/52)) did not use the term “electronic money”, but referred to “electronic money instrument” and gave the following definition at article 2(c):

‘means a reloadable payment instrument other than a remote access payment instrument, whether a stored-value card or a computer memory, on which value units are stored electronically, enabling its holder to effect transactions of the kind specified in Article 1 (1);’

The transactions can be effected by means of an “electronic payment instrument”, as defined in article 2(a) as “an instrument enabling its holder to effect transactions of the kind specified in Article 1 (1). This covers both remote access payment instruments and electronic money instruments.” The types of transaction covered in article 1(1) include the following:

- ‘(a) transfers of funds, other than those ordered and executed by financial institutions, effected by means of an electronic payment instrument;
- (b) cash withdrawals by means of an electronic payment instrument and the loading (and unloading) of an electronic money instrument, at devices such as cash dispensing machines and automated teller machines and at the premises of the issuer or an institution who is under contract to accept the payment instrument.’

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<sup>6</sup> For a discussion about whether electronic money is or can be legal tender, see Robert C Effros, “Electronic Payment Systems. Legal Aspects” in Professor Dr Norbet Horn, editor, *Legal Issues in Electronic Banking*, (Kluwer Law International, 2002).

A definition of electronic money is set out in the European Directive on the taking up, pursuit of and prudential supervision of the business of electronic money institutions (Directive 2000/46/EC of the European Parliament and of the Council of 18 September 2000 on the taking up, pursuit of and prudential supervision of the business of electronic money institutions OJ 27.10.2000 L 275/39) (Electronic Money Directive). Recital 3 describes electronic money in terms of a metaphor, and suggests it is a substitute for money in the form of coins or promissory notes, such as bank notes:

‘For the purposes of this Directive, electronic money can be considered an electronic surrogate for coins and bank notes, which is stored on an electronic device such as a chip card or computer memory and which is generally intended for the purpose of effecting electronic payments of limited amounts.’

This recital demonstrates the Electronic Money Directive is intended to give effect to the development of an electronic equivalent of cash. However, it should be noted that electronic money cannot be a substitute for coins or bank notes, because coins and bank notes are physical things in the physical world. If money is acceptable in electronic form, it will remain as currency, but not in the form of coins or bank notes. It is merely another form in which currency can be manifest.

The Electronic Money Directive provides a definition of electronic money in article 3(b), as follows:

‘(b) ‘electronic money’ shall mean monetary value as represented by a claim on the issuer which is:

- i. stored on an electronic device;
- ii. issued on receipt of funds of an amount not less in value than the monetary value issued;
- iii. accepted as means of payment by undertakings other than the issuer.’

The elements of electronic money as provided in this definition are:

(a) “monetary value as represented by a claim on the issuer” which provides for electronic money to be a form of currency subject to a claim by an issuer.

(b) The electronic money must be:

(i) “stored on an electronic device” which permits electronic money to be stored on a wide variety of devices, including mobile telephones, smart cards and computers.

(ii) “issued on receipt of funds of an amount not less in value than the monetary value issued” which indicates that the funds issued must be of a specific value and cannot be less than the monetary value issued.

(iii) “accepted as means of payment by undertakings other than the issuer” providing that some entity other than the issuer (“undertakings” appears to be used in this context as meaning “legal entity” – the meaning of which is open to interpretation) accepts the electronic money as a method of payment.

If the intention of the Electronic Money Directive was to provide for an electronic equivalent of cash, then it is possible to infer that electronic money should have the same attributes as cash, that is:

- a) Anonymity of use (with the exception of bank notes, where the serial numbers may be used to identify a holder at a point in time).
- b) The ability of a recipient to re-use the cash immediately.

The Electronic Money Directive was implemented into law by means of the Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2002 (Statutory Instrument 2002 No 682). A definition of electronic money is inserted into article 3(1) of the principal Order.<sup>7</sup> The definition incorporates much of the definition provided in the Electronic Money Directive, with two changes:

“electronic money” means monetary value, as represented by a claim on the issuer, which is -

- (a) stored on an electronic device;
- (b) issued on receipt of funds; and

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<sup>7</sup> Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, Statutory Instrument 2002 No 544, as amended by The Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2001, Statutory Instrument 2001 No. 3544.

(c) accepted as a means of payment by persons other than the issuer;’.

It will be noted that item (b) of the requirement only refers to the electronic money being “issued on receipt of funds”. Those responsible at the Treasury considered the second limb of the requirement as set out in the Electronic Money Directive, namely the wording: “of an amount not less in value than the monetary value issued” opened up the possibility of an issuer issuing electronic money at a discount, providing more value than the funds received. This, it was suggested, would mean electronic money issued at a discount would not come within the scope of the Electronic Money Directive, and would therefore fall outside the regulatory environment, and the Treasury would not be required to regulate electronic money issued in this way.<sup>8</sup> Further, the word “undertakings” has been rejected in favour of the more accurate “persons” in item (c).<sup>9</sup>

Electronic money can be considered a product, the cost of which is paid for before the value can be exchanged. It is not the same as credit provided by way of a credit card, because the customer must pay for the use of electronic money in advance in most instances. For this reason, the use of credit cards does not come within the definition of electronic money. However, where payment is made in exchange for electronic money by credit card, two contracts then come into existence: one for the sale of electronic money, and one for the credit provided by the credit card issuer.<sup>10</sup>

#### *Redeeming electronic money*

A debate ensued over the draft Electronic Money Directive as to whether electronic money was redeemable. The first proposal did not include a provision for the redeemability of electronic money. However, the European Central Bank provided a

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<sup>8</sup> HM Treasury, ‘Implementation of the Electronic Money Directive A Consultation Document’, October 2001, paragraph 13.

<sup>9</sup> See also the Financial Services Authority Handbook ‘Electronic money’ Chapter 4 Limitations on activities.

<sup>10</sup> See Financial Services Authority Handbook Authorisation Manual, Appendix 3 ‘Guidance on the scope of the regulated activity of issuing e-money’ paragraph 3.3.

number of reasons in favour of the argument that electronic money should be redeemable:<sup>11</sup>

(a) Electronic money liabilities should be redeemable at par value against the holders of electronic money because of monetary and payment systems policy, irrespective of the size of the electronic money schemes or the amount to be redeemed.

(b) Monetary policy requires electronic money to be redeemable to:

(i) preserve the unit-of-account function of money,

(ii) maintain price stability by avoiding the unconstrained issuance of electronic money, and

(iii) safeguard both the controllability of liquidity conditions and the short-term interest rates set by the European Central Bank.

(c) There must be an unconditional right to leave the relevant electronic money scheme at the discretion of the holder.

(d) Redemption payments

(i) Must be made either in legal tender or, with the consent of the electronic money holder, by way of banking channels by making an irrevocable payment order to credit the electronic money holder's bank account or an account of their choice.

(ii) To be denominated in the same currency as the currency in which the relevant electronic money liability is denominated.

(iii) To be made at the latest on the local business day following the day on which the request for redemption is received by the relevant issuer of electronic money.

(e) Where technically possible, redemption of electronic money should be allowed after the expiry date of such electronic money or of such device on which the electronic money value is stored.

(f) Disposable and reloadable cards should also be redeemable.

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<sup>11</sup> Opinion of the European Central Bank of 18 January 1999, paragraph 19.

(g) In principle, redemption should be free of charge. Fees or commissions payable on redemption of electronic money must be a reasonable and fair estimate of the costs for the relevant electronic money issuer related to the redemption. If such fees or commissions are deemed acceptable, they should be clearly communicated to customers in advance.

A provision to this effect was subsequently included in the Electronic Money Directive. Article 3 provides for electronic money to be redeemed, that the conditions of redemption must be made clear, and any threshold for redemption is also to be stipulated:

- ‘1. A bearer of electronic money may, during the period of validity, ask the issuer to redeem it at par value in coins and bank notes or by a transfer to an account free of charges other than those strictly necessary to carry out that operation.
2. The contract between the issuer and the bearer shall clearly state the conditions of redemption.
3. The contract may stipulate a minimum threshold for redemption. The threshold may not exceed EUR 10.’

The practical issue is to encourage the use of money in electronic format. Although take-up has been poor, nevertheless it might be even more difficult to encourage the use of electronic money if it is not freely redeemable.<sup>12</sup> Finally, it should be noted that when an issuer redeems electronic money, the act of redemption does not imply that the funds exchanged for electronic value are to be considered as deposits. Such funds do not constitute a deposit or other repayable fund if “... the funds received are immediately exchanged for electronic money” rather than being stored in an account.<sup>13</sup>

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<sup>12</sup> Professor Otmar Issing, “New Technologies in Payments – A Challenge to Monetary Policy”, Lecture given at the Center for Financial Studies, Frankfurt am Main, 28 June 2000, paragraph 3.2.b, available in electronic format from <http://www.ecb.int>.

<sup>13</sup> Article 2(3). See also the Financial Services Authority Handbook ‘Electronic money’ Chapter 6 Redemption, information requirements and purse limits.

## **The regulatory regime**

### *The Payments Recommendation*

The Payments Recommendation (Commission Recommendation of 30 July 1997 concerning transactions by electronic payment instruments and in particular the relationship between issuer and holder (97/489/EC) (OJ 02/08/1997 L 208/52)) remains in place as a means of guidance in relation to electronic money. While it does not have the same effect as the Electronic Money Directive, nevertheless its provisions, mainly relating the obligations of the parties to a contract for electronic money, act to regulate liability between the parties, discussed in more detail below.

### *The Electronic Money Directive*

By article 1(2), the Electronic Money Directive does not apply to the entities set out in article 2(3) of Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions (OJ 26.5.2000 L 126/1) (Banking Consolidation Directive). It only applies to electronic money institutions, which are defined in article 1(3)(a) as:

‘an undertaking or any other legal person, other than a credit institution as defined in Article 1, point 1, first subparagraph (a) of Directive 2000/12/EC which issues means of payment in the form of electronic money;’

The aim in restricting the activities of electronic money institutions is to help control the stability of the financial system and the smooth operation of payment systems, as provided for in recital 14. Further, the business activities of electronic money institutions are restricted under article 1(5) of the Electronic Money Directive as follows:

‘The business activities of electronic money institutions other than the issuing of electronic money shall be restricted to:

(a) 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 but excluding the granting of any form of credit; and

(b) the storing of data on the electronic device on behalf of other undertakings or public institutions.

Electronic money institutions shall not have any holdings in other undertakings except where these undertakings perform operational or other ancillary functions related to electronic money issued or distributed by the institution concerned.’

The aim is to distinguish between entities that offer deposit taking activities, and those that provide electronic money where the funds received are immediately exchanged for electronic money, as set out in recitals 7 and 8. Recital 9 makes it clear that electronic money must be redeemable to provide for bearer confidence, although redeemability in itself does not imply that the funds received in exchange for electronic money are regarded as deposits or other repayable funds for the purposes of the Banking Consolidation Directive. Essentially, an electronic money institution is prohibited from granting any form of credit.

#### *Capital requirements*

Article 4(1) of the Electronic Money Directive requires issuers of electronic money to have an initial capital of not less than 1 million euro, and their own funds must not fall below this figure. The issuer is also required to have, at all times, their own funds that are equal to or above two per cent of “... the higher of the current amount or the average of the preceding six months’ total amount of their financial liabilities related to outstanding electronic money.”<sup>14</sup>

#### *Requirement for authorization*

The issuing of electronic money is a regulated activity under the provisions of the Financial Services and Markets Act 2000.<sup>15</sup> The reason for making the issuing of electronic money a regulated activity was first, to prevent persons not authorized to do so (unless they have a waiver) from issuing electronic money, and second, to enable

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<sup>14</sup> Article 4(2). See also the Financial Services Authority Handbook ‘Electronic money’ Chapter 2 Initial and continuing own funds requirements.

<sup>15</sup> Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2002, Statutory Instrument 2002 No 682 regulation 4 inserting Chapter IIA, regulation 9B.

the Financial Services Authority to regulate the issuing of electronic money by making appropriate rules under s138 of the Financial Services and Markets Act 2000.<sup>16</sup>

Any entity wishing to issue electronic money is required, unless they have a waiver, to apply to the Financial Services Authority for authorization. Where an issuer of electronic money is established in the United Kingdom, or where they are established outside the European Union but carry out their business in the United Kingdom, they must apply for permission to carry on regulated activities under the provisions of Part IV of the Financial Services and Markets Act 2000. Where the applicant is an electronic money institution (i.e. they are not a bank), they are limited, in accordance with the provisions set out in the Electronic Money Directive as outlined above, to making an application for the issuing of electronic money. It is also necessary for a bank to apply for permission to issue electronic money.

Where an entity is established in other European Union Member States, and it carries on its activities in the United Kingdom, it will be required, under article 20 of the Banking Consolidation Directive, to go through a process of acceptance as part of the passport rights set out in Part II, Schedule 3 to the Financial Services and Markets Act 2000. The passport rights also apply to entities that only issue electronic money, because the definition of credit institution in the Banking Consolidation Directive was amended to include an electronic money institution.<sup>17</sup> Care should be taken to consult Chapter 2 of the Financial Services Authority Authorisation Manual to determine whether the entity is carrying on regulated activities in the United Kingdom.

#### *Supervision by the Financial Services Authority*

The Financial Services Authority supervises the issuers of electronic money by way of the Authorisation Manual and the Handbook relating to Electronic Money. Further guidance is contemplated, the purpose of which is to help people with electronic

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<sup>16</sup> HM Treasury, 'Implementation of the Electronic Money Directive A Consultation Document', October 2001, paragraph 16.

<sup>17</sup> Directive 2000/28/EC of the European Parliament and Council of 18 September 2000 amending Directive 2000/12/EC relating to the taking up and pursuit of the business of credit institutions (OJ 27.10.2000 L 275/37) Article 1(1).

payment schemes understand whether any of their proposals involve the issuing of electronic money, and to help those using a particular type of pre-paid electronic payments mechanism (such as air-time on mobile telephones, premium rate services, electronic travellers' cheques or trust arrangements) to understand the status of the mechanism under the Financial Services and Markets Act 2000. A consultation exercise was initiated that ended in May 2003. At the time of writing, consultation paper, CP172 "Electronic money: Perimeter guidance" remained current, although it will be superseded by a Policy Statement and definitive version of the new text for the Handbook.

Electronic money is not subject to the Financial Services Compensation Scheme,<sup>18</sup> although issuers of electronic money are subject to the Financial Ombudsman Scheme.<sup>19</sup> The Treasury decided to exclude electronic money issuers from the remit of the Financial Promotions Order. This means issuers of electronic money will be subject to the Advertising Standards Authority rules, although the Financial Services Authority have indicated that it will apply its Principles for Business and take action against an issuer if a firm's communications with its customers was so bad as to call into question the probity of the firm, its senior management or both.<sup>20</sup>

#### *Waiving the regulations*

Under article 8 of the Electronic Money Directive, competent authorities in Member States have the authority to waive the application of some or all of the provisions of the Directive and the application of the Banking Consolidation Directive, where the electronic money institution only operates within the territory of the Member State, for which see recital 15. The aim of the waiver is to permit those that issue electronic money in small quantities, or where a money issuer is located in a precise geographical site (such as within the confines of a university or company), to carry on

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<sup>18</sup> The Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2002 Statutory Instrument 2002 No 682 Regulation 9J.

<sup>19</sup> Financial Services Authority, 'The Regulation of Electronic Money Issuers Feedback on CP 117' page 33.

<sup>20</sup> Financial Services Authority, 'The Regulation of Electronic Money Issuers Feedback on CP 117' page 31.

their activities without requiring them to abide by the full rigour of the regulation. The Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2002 (Statutory Instrument 2002 No 682), provides for the alternative regime that applies to issues of electronic money coming within the waiver. The criteria to obtain a certificate of waiver are set out in new regulation 9C (4):

‘(a) A [“A” is the applicant] does not issue electronic money except on terms that the electronic device on which the monetary value is stored is subject to a maximum storage amount of not more than 150 euro; and

(b) A’s total liabilities with respect to the issuing of electronic money do not (or will not) usually exceed 5 million euro and do not (or will not) ever exceed 6 million euro.’

Further, the electronic money issued by the applicant can only be issued as a means of payment by, in accordance with regulation 9C(5)(c):

‘(i) subsidiaries of A which perform operational or other ancillary functions related to electronic money issued or distributed by A; or

(ii) other members of the same group as A (other than subsidiaries of A).’

Where the above conditions are met, further limitations are imposed by the provisions of regulation 9C(6)(b);

‘(b) electronic money issued by A is accepted as a means of payment, in the course of business, by not more than one hundred persons where -

(i) those persons accept such electronic money only at locations within the same premises or limited local area; or

(ii) those persons have a close financial or business relationship with A, such as a common marketing or distribution scheme.’

For the purposes of regulation 9C(6)(b)(i), the locations are to be treated as situated within the same premises or limited local area where they are situated within a shopping centre, airport, railway station, bus station, or campus of a university, polytechnic, college, school or similar educational establishment; or the geographical area does not exceed four square kilometres, in accordance with regulation 9C(7).

Where a certificate is issued, the applicant is required to provide information regularly as required by regulation 9G.<sup>21</sup>

It is to be noted that an electronic money issuer that obtains a waiver is subject to the Money Laundering Regulations 1993 and the Financial Services Authority Money Laundering Rules, because the activity of issuing electronic money comprises the “issuing and administering means of payment” within the meaning of item 5 of Annex I to the Banking Consolidation Directive. However, where an issuer obtains a waiver and is known as a “small e-money issuer”, customers do not have a claim under the Financial Services Compensation Scheme because the scheme only applies to claims in connection with regulated activities.<sup>22</sup>

## **Money laundering**

### *Electronic Money Directive*

Although there are a range of regulatory controls in place to provide for the stability of financial institutions working within the financial markets, money laundering remains an important area of concern. As a consequence, the financial institutions are subject to the relevant regulations and laws in relation to money laundering. The Electronic Money Directive provides, in article 2(1), that an electronic money issuer is subject to the provisions of the Money Laundering Directive.<sup>23</sup> Money laundering is defined in article 1 of the Money Laundering Directive as follows:

““money laundering” means the following conduct when committed intentionally:

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<sup>21</sup> Financial Services Authority Handbook ‘Electronic money’ Chapter 8 Small e-money issuers.

<sup>22</sup> Financial Services Authority Handbook ‘Electronic money’ Chapter 8 Small e-money issuers, paragraph 8.3.1.4.

<sup>23</sup> Council Directive 91/308/EEC of 10 June 1991 on prevention of the use of the financial system for the purpose of money laundering (OJ 28/06/1991 L 166/77), as amended by Directive 2001/97/EC of the European Parliament and of the Council of 4 December 2001 amending Council Directive 91/308/EEC on prevention of the use of the financial system for the purpose of money laundering (OJ 28.12.2001 L 344/76).

- the conversion or transfer of property, knowing that such property is derived from criminal activity or from an act of participation in such activity, for the purpose of concealing or disguising the illicit origin of the property or of assisting any person who is involved in the commission of such activity to evade the legal consequences of his action,
- the concealment or disguise of the true nature, source, location, disposition, movement, rights with respect to, or ownership of property, knowing that such property is derived from criminal activity or from an act of participation in such activity,
- the acquisition, possession or use of property, knowing, at the time of receipt, that such property was derived from criminal activity or from an act of participation in such activity,
- participation in, association to commit, attempts to commit and aiding, abetting, facilitating and counselling the commission of any of the actions mentioned in the foregoing paragraphs.

Knowledge, intent or purpose required as an element of the abovementioned activities may be inferred from objective factual circumstances.

Money laundering shall be regarded as such even where the activities which generated the property to be laundered were perpetrated in the territory of another Member State or in that of a third country.’

### *Legislation*

The offences relating to money laundering are contained in the Criminal Justice Act 1988, as inserted by the Criminal Justice Act 1993. The offences created are:

- (a) To assist another to retain the proceeds of criminal conduct (section 93A).
- (b) The acquisition, possession or use of the proceeds of criminal conduct (section 93B).
- (c) Concealing or transferring the proceeds of criminal conduct (section 93C).

(d) Where a person discloses to another information about an investigation that is being, or is about to be, conducted into money laundering (section 93D).

In addition, the Money Laundering Regulations 1993 require any institution undertaking activities in “relevant financial business”<sup>24</sup> to adopt the procedures set out in regulation 5:

- a) Identification procedures in accordance with regulations 7 and 9.
- b) To adopt record-keeping procedures in accordance with regulation 12 (normally to retain records for five years).<sup>25</sup>
- c) To provide appropriate internal reporting procedures in accordance with regulation 14 as may be appropriate for the purposes of forestalling and preventing money laundering.
- d) To introduce such other procedures of internal control and communication for the purposes of making employees whose duties include the handling of relevant financial business aware of the relevant procedures and provide employees with training in the recognition and handling of transactions carried out by, or on behalf of, any person who is, or appears to be, engaged in money laundering.

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<sup>24</sup> Defined in regulation 4(e) as “any home regulated activity carried on by a European institution in respect of which the requirements of paragraph 1 of Schedule 2 to the Banking Coordination (Second Council Directive) Regulations 1992 have been complied with;”. Note: the Banking Coordination (Second Council Directive) Regulations 1992 refers to the Second Council Directive 89/646/EEC of 15 December 1989 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC (OJ 30/12/1989 L 386/1). With respect to banks, this covers the activities listed in Annex I to the to the Banking Consolidation Directive, which now incorporates the Second Council Directive.

<sup>25</sup> Financial Services Handbook ‘Electronic Money’ Schedule 1 Record keeping requirements.

In addition, the Money Laundering Regulations 2001 provide for the registration of money service operators with the Commissioners of Customs and Excise. The Money Laundering Regulations 2001 aim to give effect to articles 12 and 15 of the Money Laundering Directive and add additional activities to the meaning of relevant financial business to include, in regulation 3(2)(a) “transmitting money, or any representation of monetary value, by any means.” The Treasury proposed a revision of the Regulations in November 2002, and a draft Statutory Instrument has been prepared with a view to consolidate, clarify and update the existing Regulations and to implement the requirements of the Money Laundering Directive as revised.<sup>26</sup>

### *Regulations*

The Financial Services Authority has published the Money Laundering Rules to comply with its statutory obligation to contribute to the reduction of financial crime, as set out in s2(2)(c) of the Financial Services and Markets Act 2000. These Rules are a regulatory requirement, and firms undertaking regulated activities are required to follow the Rules in addition to the provisions of the Regulations.<sup>27</sup> In many respects the Rules and the Regulations are complementary to each other, although the Joint Money Laundering Steering Group, which is made up of a number of trade associations in the financial services industry, has issued Guidance Notes on the application of the Regulations. Complying with the Guidance Notes is not mandatory, but under the provisions of regulation 3 of the Money Laundering Regulations 1993, a judge may have regard to any relevant supervisory or regulatory guidance which applies, which will include the Rules and Guidance Notes.

The not unreasonable provisions relating to money laundering tend to negate the notion that electronic money can be a substitute for money in the form of coins or bank notes. Either electronic money is to be similar to coins or bank notes and have

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<sup>26</sup> At the time of writing, the Regulations were undergoing internal government scrutiny. As a result, the various versions provided for guidance and writing purposes, and not for publication to the public, may be altered. It is not certain how long it will take for the Regulations to receive clearance, but the Treasury intends to lay them as soon as it is able.

<sup>27</sup> A number of specified firms are excluded from the Rules by paragraph 1.1.2R.

the attribute of anonymity, or it should be subject to the same controls as any other form of money not circulating in the form of coins or bank notes. A further indication of the anonymity of electronic money is demonstrated by the requirement of the issuer, in accordance with article 7(2)(c) of the Payments Recommendation, to keep "...for a sufficient period of time, internal records to enable the transactions referred to in Article 1 (1) to be traced and errors to be rectified." On balance, it appears that electronic money cannot be considered a "surrogate for coins and bank notes" as suggested in recital 3 to the Electronic Money Directive, because it lacks the attribute of anonymity associated with the physical manifestation of money.

### **Consumer protection**

The regulation of trading terms to payment instrument contracts was initially attempted by way of the Payments Recommendation (Commission Recommendation of 30 July 1997 concerning transactions by electronic payment instruments and in particular the relationship between issuer and holder 97/489/EC OJ 02/08/1997 L 208/52). Although the Payments Recommendation has no binding effect on Member States, nevertheless many of its provisions are implemented in the Banking Code, which in itself is voluntary, and only applies to banks and building societies.<sup>28</sup> However, a minimum set of rules have been introduced with the Distance Selling Directive<sup>29</sup> and the Directive 2002/65/EC of the European Parliament and of the Council of 23 September 2002 concerning the distance marketing of consumer

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<sup>28</sup> The electronic purse is discussed in paragraphs 12.12 to 12.14 in the Banking Code, March 2003. Note also the Guidance for Subscribers that states at page 44 "Although the electronic purse is not yet a product in common use, the provisions remain in the Code at the request of HM Treasury to comply with EU requirements."

<sup>29</sup> Directive (EC) 7/97 of the European Parliament and of the Council of 20 May 1997 on the protection of consumers in respect of distance contracts (OJ 20/05/1997 L 144/19).

financial services (Direct Financial Services Directive).<sup>30</sup> These Directives act to regulate the relationship between consumer and provider in addition to the regulatory framework that already exists, including Council Directive 93/13/EEC of 5 April 1993 on unfair terms in consumer contracts (OJ 21/04/1993 L 095/29) (Unfair Terms in Consumer Contracts Directive) and the regulations issued under the provisions of this Directive, together with the Unfair Contract Terms Act 1977.

The Direct Financial Services Directive applies to consumers,<sup>31</sup> and covers, in accordance with recital 14, “all financial services liable to be provided at a distance” and includes intermediaries (recital 19). In accordance with the provisions of article 21, Member States are required to bring the Directive into force not later than 9 October 2004. For the purposes of the Directive, a ‘distance contract’ means:

‘any contract concerning financial services concluded between a supplier and a consumer under an organised distance sales or service-provision scheme run by the supplier, who, for the purpose of that contract, makes exclusive use of one or more means of distance communication up to and including the time at which the contract is concluded;’

The definition of ‘financial service’ is sufficiently wide in scope to include the provision of electronic money:

‘means any service of a banking, credit, insurance, personal pension, investment or payment nature;’

#### *Information to be provided before the conclusion of the contract*

Similar provisions that apply under the provisions of the Distance Selling Directive also apply in relation to the sale of financial services at a distance. They include information concerning the supplier, the service and the contract.

#### Information concerning the supplier

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<sup>30</sup> Directive 2002/65/EC of the European Parliament and of the Council of 23 September 2002 concerning the distance marketing of consumer financial services and amending Council Directive 90/619/EEC and Directives 97/7/EC and 98/27/EC (OJ 9.10.02 L217/16).

<sup>31</sup> Recitals 23, 24 and 25. A definition is provided in article 2(d).

The following information must be provided in ‘good time’ before the consumer is bound by an offer made at a distance, as required by article 3(1)(1):

‘(a) the identity and the main business of the supplier, the geographical address at which the supplier is established and any other geographical address relevant for the customer’s relations with the supplier;

(b) the identity of the representative of the supplier established in the consumer’s Member State of residence and the geographical address relevant for the customer’s relations with the representative, if such a representative exists;

(c) when the consumer’s dealings are with any professional other than the supplier, the identity of this professional, the capacity in which he is acting vis-à-vis the consumer, and the geographical address relevant for the customer’s relations with this professional;

(d) where the supplier is registered in a trade or similar public register, the trade register in which the supplier is entered and his registration number or an equivalent means of identification in that register;

(e) where the supplier’s activity is subject to an authorization scheme, the particulars of the relevant supervisory authority;’<sup>32</sup>

#### Information concerning the service

Article 3(1)(2) sets out the range of information that must be provided about the service, including, for the purposes of supplying electronic money in the form of travellers’ cheques, item (c) below:

‘(a) a description of the main characteristics of the financial service;’<sup>33</sup>

(b) the total price to be paid by the consumer to the supplier for the financial service, including all related fees, charges and expenses, and all taxes paid via the supplier or, when an exact price cannot be indicated, the basis for the calculation of the price enabling the consumer to verify it;

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<sup>32</sup> Article 3(1)(1).

<sup>33</sup> See article 3(3) and 3(4) of the Payments Recommendation for details of the information to be given to a consumer in relation to an electronic payment instrument.

- (c) where relevant notice indicating that the financial service is related to instruments involving special risks related to their specific features or the operations to be executed or whose price depends on fluctuations in the financial markets outside the supplier's control and that historical performances are no indicators for future performances;
- (d) notice of the possibility that other taxes and/or costs may exist that are not paid via the supplier or imposed by him;
- (e) any limitations of the period for which the information provided is valid;
- (f) the arrangements for payment and for performance;
- (g) any specific additional cost for the consumer of using the means of distance communication, if such additional cost is charged;'

#### Information concerning the contract

Article 3(1)(3) lists additional items of information that must be provided:

- a) Whether there is a right of withdrawal in accordance with Article 6 and, if such a right exists, how long it lasts and what conditions must be adhered to in exercising it, including information on the amount which the consumer may be required to pay in accordance with Article 7(1), as well as the consequences of failing to exercise the right.
- b) The minimum duration of the distance contract in fulfillment of which financial services are to be performed permanently or recurrently.
- c) The ability to terminate the contract early or unilaterally by virtue of the terms of the distance contract, including any penalties.
- d) Practical instructions to enable a consumer to exercise the right of withdrawal indicating, amongst other things, the address to which the notification of a withdrawal should be sent.
- e) Which laws are taken by the supplier as a basis for the establishment of relations with the consumer before the distance contract is concluded.
- f) Clauses relating to applicable law and competent court.

- g) The language or languages used to set out the contractual terms and conditions, the prior information and continuing communications during the course of the contract.

The supplier is also required to inform the consumer whether:

- a) There is a right of redress, other than through a court (article 3(4)(a)).
- b) What, if any, compensation arrangements or guaranteed funds are available (article 3(4)(b)).

The commercial purpose of the offer must be made clear, and the information required to be provided under the terms of article 3 must be provided, in accordance with article 3(2), in “a clear and comprehensible manner in any way appropriate to the means of distance communication used, with due regard, in particular, to the principles of good faith in commercial transactions, and the principles governing the protection of those who are unable, pursuant to the legislation of the Member States, to give their consent, such as minors.” Article 4 provides that where there are other legislative requirements relating to the provision of prior information when selling financial services, any such requirements will be additional to those that apply under the Direct Financial Services Directive.

#### *Communication of the contract terms*

The supplier is required to communicate, in accordance with the provisions of article 5(1), the contractual terms and conditions on paper or on another durable medium available and accessible to the consumer in good time and before the contract is concluded. In addition, the consumer may request, as provided by article 5(3), the terms and conditions at any time during the contract and may change the means of communication used, unless the method chosen is incompatible with the contract or the nature of the service.

#### *Withdrawal from the contract*

The consumer has the right to withdraw from the distance contract. The consumer has 14 calendar days in which to withdraw from the contract, and can do so without giving a reason and without penalty, although article 6(2) lists a number of financial services to which the right of withdrawal does not apply, as set out in article 6(1). The period for withdrawal begins:

‘ - either from the day of the conclusion of the distance contract, except in respect of the said life assurance, where the time limit will begin from the time when the consumer is informed that the distance contract has been concluded, or

from the day on which the consumer receives the contractual terms and conditions and the information in accordance with Article 5(1) or (2), if that is later than the date referred to in the first indent.’

In the event the consumer exercises their rights to withdraw from the contract, they are required to inform the supplier at the address indicated by the supplier under the provisions of article 3(1)(3)(d).<sup>34</sup> Where a consumer withdraws from the contract under the provisions of article 6(1), the supplier may only charge the consumer for the service actually provided in accordance with the contract. The supplier may only make such a charge where it informed the consumer of their right to withdraw from the contract in accordance with article 3(1)(3)(a), and they were informed of the amount they may be required to pay under the provisions of article 7(1).

#### *Information subsequent to a transaction*

The Payments Recommendation requires a certain amount of information to be provided to the holder of an electronic payment instrument, as set out in article 4:

‘(a) a reference enabling the holder to identify the transaction, including, where appropriate, the information relating to the acceptor at/with which the transaction took place;

(b) the amount of the transaction debited to the holder in billing currency and, where applicable, the amount in foreign currency;

(c) the amount of any fees and charges applied for particular types of transactions. The issuer also provides the holder with the exchange rate used for converting foreign currency transactions.

2. The issuer of an electronic money instrument provides the holder with the possibility of verifying the last five transactions executed with the instrument and the outstanding value stored thereon.’

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<sup>34</sup> Article 6(6).

The text of paragraph 2 to article 4 is relevant to the ability of the customer to keep a check on the use of their electronic money. This is one way by which the customer is able to verify their transactions and identify whether their electronic money has been used without authority.

### *Obligations of the parties*

The Payments Recommendation places obligations on both the issuer and the holder in relation to the payment instrument. The liabilities of the holder are set out in article 5, where the holder:

- ‘(a) uses the electronic payment instrument in accordance with the terms governing the issuing and use of a payment instrument; in particular, the holder takes all reasonable steps to keep safe the electronic payment instrument and the means (such as a personal identification number or other code) which enable it to be used;
- (b) notifies the issuer (or the entity specified by the latter) without delay after becoming aware of:
  - the loss or theft of the electronic payment instrument or of the means which enable it to be used,
  - the recording on his/her account of any unauthorized transaction,
  - any error or other irregularity in the maintaining of that account by the issuer;
- (c) does not record his personal identification number or other code in any easily recognizable form, in particular on the electronic payment instrument or on any item which he/she keeps or carries with the electronic payment instrument;
- (d) does not countermand an order which he/she has given by means of his/her electronic payment instrument, except if the amount was not determined when the order was given.’

The provisions of article 5(d) must be considered in the light of article 6 of the Direct Financial Services Directive, which gives a consumer the right to withdraw from a distance contract without penalty for a period of 14 calendar days after the contract is concluded.

The obligations of the issuer are set out in article 7, including the right to alter contract terms with sufficient notice; not to disclose the holder's personal identification number or other code to anybody other than the holder; not to send an unsolicited electronic payment instrument except to replace such an instrument already held by the holder; to retain internal records to enable transactions to be traced and rectified; to enable the holder to notify the issuer of any incidents that the holder is required to inform the issuer about under the terms of article 5(b) and, in the event of a dispute, to adduce evidence that a transaction was accurately recorded and entered into accounts and was not affected by technical breakdown or other deficiency.

#### *Liabilities of the parties*

The liabilities of the holder of an electronic payment instrument are set out in article 6 of the Payments Recommendation. This provides that up to the time of notification, the holder bears any losses related to the electronic payment instrument up to a limit, which may not exceed ECU 150, although the Banking Code has a lower limit of £50. This limit does not apply where the holder acted with extreme negligence, in contravention of the provisions under article 5 (a), (b) or (c), or fraudulently. Once the holder has notified the issuer of the loss, the holder is no longer liable. In addition, the holder is not liable where the instrument is used on-line without the physical presentation of the instrument or electronic identification under the provisions of article 6(3). Further, the holder does not become liable where the confidential code or any other similar proof of identity is used to obtain access to the payment instrument. Although this latter provision has not been incorporated into the Banking Code or any other form of regulation in domestic law, it is a powerful argument to prevent issuers from failing to provide adequate security measures when a payment instrument is used on-line.

The introduction of the Distance Selling Directive has served to amend some of the provisions of the Payments Recommendation, especially the provisions of article 6, in that article 8 of the Distance Selling Directive allows a consumer to cancel a payment where fraudulent use has been made of a payment card, and any sums deducted are to be reimbursed. This amendment is not reflected in the Banking Code, which states, at paragraph 12.13, that a holder of an electronic purse will be liable for the first £50 of unauthorized withdrawals. If the Banking Code is correct, then the holder's liability is

identical to the loss of cash. Article 8 of the Distance Selling Directive relates to “a payment card”, the meaning of which is not defined. Whilst the position in relation to electronic money stored in an electronic purse is not clear, it may be possible to argue that payment card includes an instrument incorporating electronic money within the meaning of the Distance Selling Directive. Regulation 21(6) of the Consumer Protection (Distance Selling) Regulations 2000 (Statutory Instrument 2000 No 2334) defines “payment card” to include credit cards, charge cards, debit cards and store cards. If an electronic payment instrument does not come within this definition, it is doubtful whether article 8 of the Distance Selling Directive applies to electronic payment cards. In any event, electronic payment instruments issued by banks do not come within annex II of the Distance Selling Directive or schedule 2 of the Consumer Protection (Distance Selling) Regulations 2000.

The liabilities of the issuer are set out in article 8, as follows:<sup>35</sup>

- ‘(a) for the non-execution or defective execution of the holder’s transactions referred to in Article 1 (1), even if a transaction is initiated at devices/terminals or through equipment which are not under the issuer’s direct or exclusive control, provided that the transaction is not initiated at devices/terminals or through equipment unauthorized for use by the issuer;
- (b) for transactions not authorized by the holder, as well as for any error or irregularity attributable to the issuer in the maintaining of the holder's account.’

The issuer is liable to the holder of the electronic money instrument for the total amount of the value stored on the instrument and for the defective execution of the holder’s transactions, where the loss is attributable to the malfunction of the instrument, of the device or terminal, or any equipment that is used with authority, providing that the malfunction was not caused knowingly by the holder or in breach of article 3(3)(a).<sup>36</sup> The quantum of liability, as provided for in article 8(2), includes the amount of the unexecuted or defectively executed transaction and any interest thereon, and the amount required to restore the holder to the position they were in

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<sup>35</sup> The liabilities of the issuer are subject to articles 5, 6, 7(2)(a) and (e).

<sup>36</sup> Article 8(4).

before the unauthorized transaction took place. Matters relating to claims for any additional type of loss, including further financial consequences, will be treated in accordance with the law that applies to the contract concluded between the parties, as set out in article 8(3).

In the event of a dispute over a transaction, article 7(e) provides that the burden of proving the transaction was recorded accurately is on the issuer. The Banking Code has similar provisions at paragraph 12.10. The Distance Selling Directive left this issue to Member States (article 11(3)(a)), and regulation 21(3) of the Consumer Protection (Distance Selling) Regulations 2000 provides that where a consumer alleges that the payment card was used without their authority, it is for the issuer of the card to prove it was authorized by the consumer.

The Payments Recommendation was the subject of a study in 2001<sup>37</sup> and identified a number of problems in relation to the Recommendation's aim to create transparency of conditions for transactions: issuers failed to provide sufficient information to holders; the information that was provided lacked clarity, or was not easily available, or both lacked clarity and was not easily available; issuers failed to provide information at the appropriate time; and levels of compliance on this matter differed according to the type of Electronic Payment Instrument (EPI).

Issuers often fail to comply with the Recommendation in relation to the obligations and liabilities of the parties to the contract in the following respects:

- ‘5.2.1 Failure to limit a holder’s liability after notification;
- 5.2.2 Failure to restrict liability when the EPI is used without physical presentation or electronic identification;
- 5.2.3 Lack of uniformity in relation to what constitutes gross negligence across the Member States;
- 5.2.4 Notification period for changes to the contract is often less than 1 month;

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<sup>37</sup> Jean Herveg, Jean-François Lerouge, Anne Salaün, Laura Edgar, Chris Reed, Sonia Gonzalo and Dominique Spaey, “Study on the implications of Recommendation 97/489/EC”, 17 April 2001.

5.2.5 Countermanding provisions for unspecified sums are very rare;

5.2.6 Failure to provide for the liability of the issuer for defective or non-executed transactions.

5.3 Many issuers do not comply with the Recommendation in respect of the procedure for notification of loss or theft and the issuer's liability after notification:

5.3.1 Some issuers do not explain the notification procedures;

5.3.2 In many cases no special means are provided to prove that the notification has been made;

5.3.3 Some issuers offer only limited access to notification systems, e.g. by restricting operating hours.

5.4 In most Member States the burden of proof is placed on holders, or at best not stated in the EPI contract terms.

5.5 The means for settlement of disputes are inadequate in that:

5.5.1 Contracts often make no reference to dispute resolution bodies nor provide their contact details;

5.5.2 Dispute resolution bodies are often internal, and thus lack independence;

5.5.3 Costs of judicial action are prohibitively high, and the procedure extremely slow.'

The main problems identified in relation to electronic money instruments<sup>38</sup> and electronic tokens<sup>39</sup> are in the case of electronic money instruments:

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<sup>38</sup> Jean Herveg, "Study on the implications of Recommendation 97/489/EC" define electronic money instruments as: 'reloadable payment instrument which stores monetary value and from which an amount is deducted each time a payment is made. The reloadable character of the instrument allows it to be reloaded with new monetary units each time it is needed;' page 21.

- ‘ - lack of information provided to holders,
- limitations of the holder’s liability are not always respected in case of loss or fraudulent use,
- a 24 hours a day notification service does not always exist and the holder receives no means to prove the notification,
- in most cases, the burden of proof lies on issuers,
- compliance is not complete for the settlement disputes,
- Denmark is the only country that appears to be fully compliant with the recommendation.’<sup>40</sup>

The main issues in relation to electronic tokens (which are only available in four countries)<sup>41</sup> are:

- ‘ - no maximum amount of liability (although liability is limited itself by the storage limit);
- no requirement regarding the means to prove the notification;
- no reversal of the burden of proof in favour of the holder.’<sup>42</sup>

The findings of this report illustrate that the issuers are failing to abide by the terms of the Payments Recommendation, which only acts to increase the exposure of issuers to the general laws on Member States relating to unfairness in contract terms in any event. Whilst there has been a great deal of activity to resolve payments electronically, the systems provided by operators must, of necessity, be ‘closed’ and

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<sup>39</sup> Jean Herveg, “Study on the implications of Recommendation 97/489/EC” define electronic tokens as: ‘monetary value stored on the memory of a computer that allows payment to be made in a digital environment like the Internet.’ Page 21.

<sup>40</sup> Jean Herveg, “Study on the implications of Recommendation 97/489/EC” page 23.

<sup>41</sup> The number of countries that have electronic tokens is mentioned as four on page 24, but the table on page 51 ‘Compliance across the considered EPI: Electronic Tokens’ only mentions Germany, The Netherlands and the United Kingdom.

<sup>42</sup> Jean Herveg, “Study on the implications of Recommendation 97/489/EC” page 24.

only open to subscribing parties. It does not appear that electronic money will have the same attributes as money in its physical manifestation, such as cash or bank notes.

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