

Client Alert

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Cloud Computing: A move towards harmonization, or continuation of a tiered service provision?

By Alistair Maughan

Regulators in Europe have continued to publish guidance notes designed to encourage the take-up of cloud computing services. As we report in this Alert, the views of the UK financial services regulator on the risks and issues inherent in cloud usage are likely to be welcomed by regulated financial services firms with UK operations. By contrast, although the EU's aim is more lofty (to close the gap between cloud providers and customers, no less), it has moved more slowly and has yet to produce anything specific enough to cause potential cloud adopters or providers to rush to change their plans.

In July 2016, the UK's Financial Conduct Authority (FCA) published its final guidance for UK regulated financial services firms outsourcing to the cloud and other third party IT services (the "FCA Guidance"). Importantly, the FCA clearly states that there is "no fundamental reason" why financial services firms cannot use public cloud services, as long as they comply with the FCA's rules. Of course, for U.S.-based or operating financial services firms, the guidance published by the federal financial regulatory agencies – now more than 4 years ago – will also be relevant.

We previously reported on the FCA's issue of its draft FCA Guidance, published in November 2015, and the final issued FCA Guidance contains some relevant changes based on feedback during the consultation period.

However, the FCA is not the only European body to publish recent guidance in relation to cloud computing. Shortly before the FCA Guidance came out, an EU-funded body known as SLALOM produced a set of cloud service level agreement (SLA) guidance notes designed to close the gap between customer and provider.

Of the two issued guidance notes, the FCA is clearly the most persuasive – coming from a national regulatory body with clear authority over a sector of the economy with much pent-up demand for use of the cloud that was being held back for fear of regulatory concerns. The SLALOM SLA guidance is much broader and less likely to have a direct impact – unless, of course, one agrees with the proposition that centrally standardized legal and technical terms will promote the take-up of cloud services in Europe faster than is already happening in a market that's largely and mercifully free from preventative regulation.

FCA GUIDANCE

As we previously reported, the FCA Guidance is relatively high-level and risk-based, in line with most of the FCA's guidance notes. Many of the criticisms on the draft FCA Guidance appeared to focus on this aspect of the FCA's approach, and the updated FCA Guidance does not make significant amendments in this regard.

Client Alert

The basic structure, content and approach of the FCA Guidance has not changed since [our summary of the initial published draft](#). However, after consultation, the FCA has chosen to make a number of amendments which may be of interest to regulated firms seeking to exploit cloud computing services.

- **Supply Chain Identification.** In response to concerns that the FCA expects firms to identify all of the service providers in a supply chain, the FCA has agreed that identifying *all* providers may not always be necessary. The FCA Guidance now makes it clear that identification only applies where the service providers “are related to the regulated activity being provided”. While any clarification is no doubt welcome, since a lot of a regulated firm’s activity with providers is likely to relate to regulated activity, this amendment may not actually be of much practical benefit.
- **Cloud Data Locations.** Among the key concerns about the use of cloud services in regulated financial services markets has always been the degree of knowledge and control (and auditability) of locations of data storage and processing. In response to concerns about a financial services firm having “choice and control” regarding the jurisdiction in which its data is stored, processed and managed, the FCA has acknowledged that firms may well not be able to have full “choice and control”. Instead, the FCA Guidance now states that a firm should “agree a data residency policy with the provider upon commencing a relationship with them, which sets out the jurisdictions in which the firm’s data can be stored, processed and managed. This policy should be reviewed periodically.” This change will be welcome by regulated firms because it emphasizes the need for them to maintain choice and control, but more realistically reflects how a firm’s relationship with a cloud provider will work in practice. Many large cloud providers now offer ring-fenced geographical cloud options, and this change seeks to marry regulated firms’ needs with provider offerings.
- **Access to Data Centres.** In response to concerns around the issue of physical access to data centres, the FCA did not change its stance and emphasized that there may be circumstances where physical access is required for a firm to meet its regulatory requirements. With the “one size fits all” model of cloud service provision, providing access to data centres will likely be heavily resisted by cloud providers, despite the FCA Guidance. Either cloud providers will have to relax their attitudes to audit rights as a result of this provision or, perhaps more likely, this requirement may well lead to protracted negotiations with cloud service providers as regulated firms continue to argue that such access is required.

The key takeaway is that the FCA has finally produced something to fill the vacuum left by its previous silence on cloud computing issues. The FCA Guidance gives regulated financial services firms assurances that, as long as they comply with the FCA’s rules and guidelines, outsourcing to the cloud is permissible. At least regulated UK firms now have a framework that can be used as a structure to guide compliance with the FCA’s rules when adopting cloud-based services.

The challenge for regulated firms will be to use the FCA Guidance to create an appropriate framework for assessing cloud-based risks, determining which services can be sourced via the cloud while still ensuring compliance, and making key decisions on what risk mitigation factors are necessary to counteract any gaps between the FCA’s expectations and what cloud providers might offer as part of their solutions.

Client Alert

CLOUD AND THE DIGITAL SINGLE MARKET

Cloud computing plays a key role in the European Commission's vision for an EU Digital Single Market.

As we have already reported, The EU's Digital Single Market strategy contains, in Pillar 3, a number of activities designed to maximize the growth potential of the EU digital economy. This includes a European Cloud Initiative, a European Free Flow of Data Initiative and the development of responses to emerging issues related to ownership, access, portability of data and switching of cloud service providers.

The European Cloud Initiative is focused on:

- an initiative on the digitization of industry that seeks to develop a European Open Science Cloud, a trusted, open environment for storing, sharing and re-using scientific data and results;
- a proposal to establish a European Data Infrastructure, a world-class digital infrastructure to securely access, move, share and process data in Europe;
- actions to promote the development and uptake of cloud services, focusing on certification, switching of cloud service providers and security; and
- actions to promote the take-up of cloud computing, in particular for small and medium-sized enterprises (SMEs).

These actions incorporate input from the European Cloud Partnership (**ECP**) set up under the 2012 Cloud Strategy and the Cloud Select Industry Group (**C-SIG**). The European Commission identifies the development and adoption of cloud computing standards as one of the five priority areas in which standardization will increase the market potential for digital services in Europe.

However, so far the European Commission has not produced draft legislation in this area.

THE SLALOM TERMS

As noted above, the EU has encouraged a number of initiatives designed to align cloud industry standards. SLALOM is an initiative partly funded by the European Commission, set up in 2015 to help drive the uptake of cloud services. It has produced a series of proposals designed to close the perceived gap between cloud customers and providers – including a series of three deliverables designed as a specification for cloud SLAs.

The SLALOM Legal and Open Model Terms for Cloud SLA and Contracts (the “**Terms**”) can be considered a natural follow-on from the European Commission's Standardisation Guidelines on which we previously reported in July 2014.

The Terms, designed to be a standardised set of terms to be used by service providers and end users, contain clauses which are intended to balance the often polar opposite stances of a service provider and end user. These clauses relate to a number of aspects of cloud computing, including the issues addressed below.

1. *Service levels.* SLALOM notes the need for clear and measurable technical conditions of service delivery to be set out in the agreement. This will allow end users to compare service levels of different cloud

Client Alert

providers. Such service levels should be reported on periodically in order to assess violations and any service credits which are subsequently due.

2. *Service variation.* SLALOM proposes that changes are entitled to be made by providers, but that such changes should not determine in any way a reduction of the functionalities or characteristics of the services as offered at the effective date of the agreement. If such changes are required, they need to be approved in writing. The only exception to this will be if such changes are required to fix defects or security vulnerabilities, or in the case of changes required due to applicable law. However, in each case, if a reduction in functionality occurs, the parties should meet to decide an appropriate reduction in charges.
3. *Term and termination.* SLALOM proposes no automatic renewal, in order to allow the parties to meet to evaluate and discuss the renewal of an agreement with any relevant conditions. Termination for breach should only be permitted following an opportunity to cure such breach. Upon termination or expiration, the provider should return the data to the end user, or transfer it to a new provider (such transfer being at the end user's expense, except in the event of a breach by the provider). The provider should then delete or destroy all end user data.
4. *Liability.* SLALOM proposes a cap on liability that is linked to whether the services being provided are those which are the core business of the end user vs. those which are not fundamentally important to the end user. Breaches of confidentiality, data protection provisions and intellectual property rights should not, however, be subject to this cap.
5. *Indemnification.* SLALOM proposes that this focuses on IP infringement and breaches of the acceptable use policy. While the limitation of liability will not apply to the IP indemnity, it will apply to any breach of the acceptable use policy.
6. *Suspension of services.* SLALOM proposes that suspension is only permitted without notice if there are serious risks to the system or services of the cloud provider, or in the event of fraudulent or illegal activities of the end user. Any suspensions required for technical reasons, or for other breaches, should occur upon notice.
7. *Data protection.* SLALOM makes it clear that these provisions will need careful tailoring dependent on the details of the processing actually being carried out by the cloud provider.

In publishing the Terms, the intention is to make it easier for SMEs to enter the cloud services market. In particular, if cloud providers utilize these Terms, it will be easier for end users to distinguish between providers, each of which currently tend to use bespoke contracts with different terminology, raising drafting costs and making comparisons between providers much harder to distinguish.

SLALOM has identified many of the most challenging aspects of cloud computing and as-a-service contracts. The reaction of many in the cloud industry will be: So what? As anyone knows who has negotiated – or tried to negotiate – a cloud contract with a large provider, getting that provider to move away from its standard terms can be a difficult task. Pointing to the existence of the SLALOM terms is not likely to get providers to budge from

Client Alert

established positions. There is enough new business coming through to please most cloud providers, and most are not geared to do individual negotiations. Also, most cloud buyers compare prices and services but not legal terms. That may change over time, of course, and the Terms do help to establish a middle ground. But on individual cloud projects, the Terms are likely to present little more than a (probably unlikely to be fulfilled) wish-list.

WHAT'S NEXT?

The publication of the FCA Guidance is welcome news to financial services firms that wish to use cloud services within their organizations. The FCA Guidance may also indirectly benefit other firms because, for example, the FCA Guidance in relation to access and audit rights may lead to a gradual “softening” of the cloud providers’ approach in this area. Alternatively, of course, it may lead to the opposite approach to that desired by SLALOM *i.e.*, a two tier approach to service provision, with better rights for those firms regulated by the FCA that can rely on the FCA Guidance to push for better terms in negotiation, as compared to SMEs that have no such leverage.

Taking the information above as an example, and given the variety of services which are provided by cloud providers and the different end users who sign up to such terms, it seems rather optimistic of SLALOM to expect a standardized set of terms which are applied to all end users to be adopted across the industry. However, the publication of the Terms should help SMEs at least be aware of the areas where risks lie, and that can only be a good thing.

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