

Internal Market and Services DG - Unit E2
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BELGIUM

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Green Paper on On-line Gambling in the Internal Market

In response to the request for information promulgated by the European Union (EU) in its Green Paper on On-line Gambling (published 24 March 2011), my personal comments are attached. I have provided more detailed input on the 51 questions posed in that Green Paper within collective submissions forwarded separately by the relevant bodies.

This personal contribution is therefore aimed at providing insight to the fundamentals of this sector which, as the Green Paper confirms, are poorly documented. In the 9 pages attached, I have adopted a 'top down' approach to emphasise some significant issues that do not appear to be generally recognised. I am available to enlarge on any or all of these points upon request. The intention of the information provided is to highlight issues requiring attention and to challenge some superficial 'received opinion' that has appeared to dominate regulatory policy setting regarding on-line gambling to date.

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Given the difficulties of applying governance principles to on-line gambling, I hope that the EU can strive towards alignment in future policies, procedures and practices to reduce confusion. When on-line gambling moved into Europe in 1999 the EU did not address the difficult issues that inevitably arose; problems were left to be handled at the national level, but this approach has failed as the industry has grown, matured and gained public acceptance across the region without co-ordinated oversight or monitoring.

I advocate learning from the on-line gambling industry rather than seeking to deny or 'demonise' this sector. Morally there seem to be similarities between the gambling, brewing and tobacco sectors, although enforcement and taxation issues may differ!

Moreover, while the fraud risk and financial impact of Hedge Fund activities may ultimately prove far more significant than those arising from on-line gambling to the EU Internal Market, Hedge Funds have been harmonised across Europe under a light touch regulatory framework that cannot fully mitigate the systemic risks involved. (Both Hedge Funds and On-line Gambling are just a decade old and present new challenges).

I am well qualified in Information and Communications Technologies (ICT), auditing and management and believe in the promulgation of professional ethics and appropriate standards without stifling innovation. My motivation in contributing to this Green Paper consultation is thus to promote reference to *best practice* in this sector in the long term interest of all stakeholders (consumers, operators, investors, governing bodies and service providers) and to foster improved mutual understanding.

I am independent of all vested interests, but have been closely associated with this industry sector since 1999 when I advised the States of Alderney on the creation and design of its Control Systems Specification; notwithstanding subsequent amendments, the original concept remains the foundation on which the claim is made that the Alderney Gambling Control Commission is the global regulatory benchmark today. In Malta, I established the current Lotteries and Gaming Authority (LGA) Compliance and Control framework applicable to the majority of licensed European-facing operators. I left the LGA in 2006 and have had no influence on the evolution of LGA policy since. More recently I have assisted a number of on-line gambling operators with the design of their internal controls.

There is a great need to apply ‘enlightened self-interest’ when ‘regulating’ this industry – controls must be cost effective, reasonable and enforceable. Principles-based regulation seems more appropriate than inflexible prescriptive rules. Regulators should not be allowed to become isolated dictators or political puppets. Transparency is essential.

Effective ‘regulation’ of on-line gambling seems impossible until the disjointed EU legal framework is rationalised. Currently, unlicensed operators trade profitably so licensing appears optional, rather than being strictly enforced. As many licensed operators in some EU jurisdictions are treated as criminals by other Member States, the advantages of being licensed on a national basis are questionable. This situation is not in the interests of the EU consumer nor of investors, as there is no single point of contact to indicate which operator is legal and which may be dubious.

An impartial, enlightened and informed pan-European approach to regulating on-line gambling in the interests of all stakeholders is well overdue. This requires more thought than simply taxing the industry and treating it as a convenient revenue stream.

Applying ICT Governance principles to this sector (and, indeed, to all other ICT dependent financial services in due course) is *essential* to the interests and credibility of the EU. There is much to learn from the issues raised by on-line gambling that have much wider application to banking and telecommunications.

The Green Paper consultation is a welcome step which should generate plenty of comment. Any queries on the notes below may be sent to amazon@pobox.com My submission should be read and published as attached, not merely redacted and merged with other comments in a manner that may destroy the message conveyed.

Melody Morgan-Busher

**Attachment to letter dated 25 July 2011 by
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CONTEXT

The EU offers diverse, but consequently somewhat parochial, perspectives on the emotive subject of on-line gambling. The ‘Walled Garden’ approach now emerging runs contrary to the EU’s single market principles and also seems impractical given available workarounds offered by technology. The EU’s apparent deference to Member States’ varied policies appears contrary to ‘Open Internet’ and declared Information Society regional strategies.

Rather than on-line gambling being regarded as a unique ‘problem’ with unknown issues, it makes much better sense to rely on established *best practice* for ICT Governance and Information Security along with the vast experience available from regulated sectors such as finance and telecommunications. The unregulated roots and commercial pressures of on-line gambling, however, render it far more dynamic and thus seemingly more risky, than most comparable sectors. Instead of regarding this challenge as a negative, on-line gambling may instead be seen as a pathfinder for the better management of globalised, distributed commerce and something of a case study in pan-European co-operation.

As a result of the poor standing of this industry sector to date, there has been little investment in the academic research of on-line gambling. In consequence there is a shortage of authoritative or independent reference publications and consequently over-dependence on any available data or comment found in the public domain. The source and reliability of many cited ‘experts’ is rarely checked or declared. Much of the information available has in fact been produced by the on-line gambling operators themselves through advertisement, sponsorship or other placement (such as annual reports or press releases).

Regulators have also not been above ‘self publicity’ in the quest to entice new licencees and to bolster their standing in a field where so little is certain. Moreover, independent authors are cautious of comment that may be considered negative by on-line gambling operators for fear of litigation by such well-funded businesses.

The inherent ICT dependence of on-line gambling is often overlooked. Indeed, ICT as a sector in general is poorly overseen by the EU; for example, there appears to be no broad spectrum mandatory requirement for formal ICT Business Continuity Planning in most regulated industries and a rather weak response to the growing problem of cyber crime. Inevitably these result in a widely held perception that the abuse of ICT, or the theft of intangible assets, is free of legal sanction, may be conveniently blamed on ‘a technical hitch’ and is therefore almost risk free – for both the individual perpetrator (often an employee) and the relevant company directors who have failed to apply adequate control.

Another global trend influencing directly the governance of on-line gambling is the phenomena of ‘data explosion’ which challenges the management and protection of

information in all corporations. This – combined with rapid software development methodologies, virtualisation, mirroring, mobile devices and complex system design – make the segregation and integrity of sensitive information difficult to assure. Although on-line gambling operators often opt to keep all commercial data indefinitely, they may well limit the volume of logs or audit trails generated or retained (even though these may be required to perform digital forensics) to reduce the cost of data storage and backup. Future regulation of on-line gambling should include core aspects of data governance to ensure that adequate (but not excessive) evidence is preserved and retained securely.

The absence of software design standardisation in on-line gambling, together with the value of player database records, indicates the need for a regular, high-level risk assessment for each operator in order to ascertain what is collected, where this data resides and who has access to it in the normal course of operations. These concepts concerning the management of sensitive information are not in any way revolutionary; indeed, they are already enshrined in the EU's Data Protection Directive! Such an approach would be relatively cheap for the industry and easily applied, given the relevant ICT understanding, yet could make significant improvement to the standards in this industry were the Regulator to review such operational risk assessments in a manner similar to that applied in other regulated financial services.

Related to the poor attention given to managing generic ICT related risks (and the consequent lack of EU case law regarding negligence by Directors regarding lack of ICT Audit or Internal Audit), the use of EU Directives to guide legal policy across Member States appears a clumsy process that cannot keep pace with cultural trends (such as the altering view of 'privacy' in the Facebook generation), nor with the technical threats arising from increased connectivity. Such slowly evolving legal frameworks merely stimulate innovative methods to anticipate or exploit "loopholes"; far from delivering a unified EU 'free market' with shortened supply chains and increased consumer choice, present eCommerce strategies within the EU tend to promote infinitely extended supply chains to bypass tax, audit or national regulations making governance ever more difficult. It seems that the market adapts far faster than the law – and that the law is decided in ignorance of technical practice or potential. Alignment of law and ICT order is needed.

There is extensive use of outsourcing in most ICT 'Departments' today due to the increasing specialisation of skills. Whilst informed and well managed delegation is often commercially justified, there can be no effective control of ICT if top management (and the relevant Regulator) lack enough ICT insight to set and monitor specific, measurable, achievable and realistic targets for delegated ICT processes. Too often, ICT-dependent businesses (banks and insurance companies, just as much as on-line gambling operators) choose their outsourcing partners on the basis of cost rather than skills or quality – a mistake that is not manifest until serious failure occurs in the absence of valid assurance checks. Rarely is any 'Right of Audit' included in ICT service contracts and even more rarely will any such legal right be exercised. It is *vital* that Regulators appreciate this weakness in the implementation of mandated controls so as to perform relevant 'due diligence' on all outsourcing relationships (in a manner analogous to that used to seek out Ultimate Beneficial Ownership) when evaluating significant 'business associates'.

Regulators need to confirm not only that proper policies and procedures are set, but that these are legally and operationally enforced when outsourced.

Given the observation that on-line gambling today involves long supply chains and complex ownership structures that cross many corporate and jurisdictional boundaries, accountability can be dubious. Furthermore, many operators protect their commercial interests by seeking multiple licences for the same or related operations (to reduce their Regulatory Risk) which may introduce confusion in the absence of co-ordination between regulators. It seems inherently unwise to regulate an international business at any level lower than regional - although market access and taxation may be managed nationally within a regional framework, since operators normally manage their marketing, accounting and support at national level.

Trust and marketing are vital to the profitability of authentic on-line gambling operators so these entities are keen to work within a regulated market, but only so long as the controls applied are tolerable. In the absence of realistic regulatory requirements, which provide some marketing benefit, licensed on-line gambling will become the domain of the 'Big Boys' (large operators who have the financial resources to withstand severe regulatory overheads imposed, but who may not offer the best service) or the 'Cowboys' (high risk appetite operators who attempt to bluff their way through licensing and are very likely to fail their customers since they lack a control culture). Conservative professionals are unlikely to invest their reputation in a sector that remains subject to ineffective or whimsical regulation.

MARKET

It is important to recognise that the remote nature of on-line gambling makes acquiring customers (also known as players or gamblers) the most critical and expensive aspect of the operation. Given the nature of this crowded and highly competitive sector – and the apparently insatiable demand for its services – operators are forced to invest heavily in marketing to obtain the critical mass required for profitability. Attractive offers and frequent game updates are important to retaining customers. This reality impacts the regulatory approach directly as only controls that fit with a dynamic business (content and systems are always in flux) and which can accommodate mass customisation (to serve various market segments with specific language, sports, terms, etc) will succeed.

Historically few customers have shown interest in the licensing status of their operator; most gambling consumers judge an operator by features such as games, bonuses, payouts, customer care, payment methods, languages ... if the operator offers a good service and is well recommended, the endorsement of a licensing authority adds little marketing advantage. Investors, financial institutions and business associates are much more likely to require a formal operating licence and so provide the motivation for regulated activity. European regulators have stated publicly that they believe that only about 15% of the on-line gambling conducted by EU citizens in Europe is transacted with regulated operators at present. The data upon which this is based is not clear nor is it known if the 85% of

unregulated (and thus unmetered) activity refers to numbers of players, value of gambling revenue or the volume of Internet bandwidth routed to on-line gambling operators. Whichever metric is applied (numbers, value or traffic), this consensus implies that an operator can trade very successfully in the EU without official sanction and so 'regulation' today is effectively a voluntary option for most EU-facing operators.

Given the potential global market for on-line gambling, it is important to appreciate the reasons that operators restrict their marketing and catchment to particular nations (as most do). Operators often suffer extortion and exploitation by players (from blackmail threats through financial frauds to bonus chasers) and so prefer to work within markets that they know well and where they can apply player verification and profiling to manage their operational risks. National markets also vary in their profitability due to the level of interest or the affluence of customers – as well as the degree of fraud risk. Gaining legal access to a few of the largest and most affluent markets may justify investment in licensing and compliance. However the prospect of 27 different EU Member State licences will be prohibitive for most operators and will lead to a fractured market. The end result may be that expensively developed local regulation will be ignored in most minor markets leaving them to be served exclusively by unregulated operators.

TECHNICAL

As indicated under 'Context' above, there are many established and proven definitions of 'ICT Best Practice' that may be usefully applied to on-line gambling – from the Information Security Management Standard ISO-27001 to COBIT principles adopted by the European Central Bank (ECB). External Auditors have developed formal auditing checks for ICT-dependent clients (to confirm the 'going concern' status of the auditee) and there are also many applicable standards concerning Business Continuity Planning, Data Protection, and ICT Service Management etc.

There are some additional specific national standards applicable to on-line gambling, sector specific self regulatory specifications and a CEN workshop agreement published in 2010 – all of which seek to tailor generic standards to the on-line gambling industry's needs while addressing public interest concerns.

Licensed on-line gambling has been subject to locally defined regulations in the EU in the last decade yet is still exempted from any independent definition of ICT best practice or third party standards despite the criticality of ICT operations to the sector. The discipline of applying a relevant standard can help to stabilise an organisation. Contrary to some negative prejudices, standards can be applied to micro-organisations and can also enable rapid change. Standards are very cost effective when intelligently applied.

Given the commercial pressures ('speed to market' trumps quality in terms of software development priority in this sector) and the complexity of the systems and supply chains involved (most controls are automated so are open to covert tampering or simple error), it is unwise to complacently assume that risks are well managed in the absence of standards

or independent monitoring. Currently the only mandated audit of ongoing operations in this sector is conducted by the External Auditors which may be up to 18 months after the time of the events reviewed and cannot address technical issues adequately. External Audit is the wrong tool to use for forward-looking IT Governance assurance. Moreover, given the potential for rapid growth or swift decline faced by on-line gambling operators, an annual review may well prove too late to protect customers. The adoption of relevant standards may provide a baseline for continuous, rather than periodic, monitoring.

Regulators and operators continue to invent local specifications instead of referencing the available body of professional knowledge. If more qualified and certified professionals were engaged in the sector, the promulgation of ICT best practice would be accelerated.

Regulators have tended to carry over their experience in managing land-based operations into the on-line domain and often focus on game fairness rather than recognising that the automated controls present a greater opportunity for abuse or error when operations are highly automated. On-line gambling presents a different threat profile with many control advantages over traditional gambling (for example, the history of players is more easily monitored than was true off-line), but the perimeter that requires safeguard from attack is vastly increased. Not only must live data on the live servers be protected, but so should all copies (backups, development, testing, and marketing) and all access points whether local or remote. It is impossible to audit effectively without inside knowledge of the whole system design and the complete system development lifecycle.

Where data is shared across an extended supply chain, the ownership and responsibility of information are often obscured. Control is closely coupled with ownership in the real world and this established legal premise needs to be clarified in on-line gambling. Too often the contracts drawn up between on-line gambling partners cover only the commercial aspects of their relationship and fail to adequately define the responsibilities of the parties providing essential technical services or support. Very often contracts are not even read or signed; it is almost unknown for such contracts to be tested in court.

All of these 'Technical' comments reflect the informal, dynamic and flexible nature of on-line gambling which is a perfect example of 'Pure Play' eCommerce. The comments are not criticisms as the same commercial pressures and innovative business models are gradually pervading other forms of eCommerce. The response of Regulators should be to re-model their expectations and design new methodologies of monitoring and governing. On-line gambling is merely the 'bleeding edge' of eCommerce and globalisation. To seek to suppress or ignore these trends is to ignore the impact of ICT on business, culture and government generally. The style of taxation applicable to eCommerce may need to be adjusted in future – to become transaction based rather than reliant on grossed up data.

OPERATIONAL

In my considered professional opinion, the piecemeal approach to on-line gambling regulation (which is driven without adequate business or technical insight) has resulted in excessive 'Regulatory Risk', which in turn inhibits long term investment by operators and leads to yet more commercial and control failures. Weak or inconsistent regulation is thus counter-productive as it can result in poorer consumer protection; currently many mature operators hold back, leaving the field open for less stable operators.

Today the complexity of ICT systems tends to exceed the competence of control systems to monitor all threats, resulting in a retreat from 100% testing and 100% auditing (as was possible with manual systems). To cover this ever-growing gap, most business and regulators now claim to apply 'Risk-based Management' by which their assurance and audit resources are applied to the risks judged most significant. However the rationale behind the Risk-based Management approach is rarely examined and is often faulty.

A Risk Management approach to on-line gambling prompts the following observations:

- a) Whilst regulators and operators may claim to apply 'Risk Management' to the management of their control systems, few can show any form of 'Risk Register' or regular systematic risk assessment. The absence of such fundamental analyses undermines their claims and indicates that 'Risk Management' is no more than a disguise for reduced assurance or ignorance. Proper Risk Management involves constantly updating and referencing the Risk Register to record issues and check symptoms – a means of building up organisational intelligence and providing continuous improvement. The sharing of Risk Registers would be a useful means of Regulatory collaboration that would help to 'normalise' the approach of regulators across all member states. Disclosing sanitised risks seen or suspected would not compromise business confidentiality, but would stimulate debate.
- b) Given the dynamic nature of on-line gambling (and the inherent uncertainty of each transaction's value when dependent on the outcome of a random event), there is an undeniable risk of fraud – by the customer, the staff or the operator. This fraud risk indicates the need for strict controls, but the software that provides the controls is usually developed and managed by the same team that runs the operation, resulting in a self-evident 'conflict of interest' or 'self audit' situation. A proper Internal Audit function could mitigate this issue, but is rarely found in on-line gambling. Were 'Risk-based Management' sincerely adopted for this sector, it would inevitably result in the expectation and funding of Internal Audit – by both Regulators and operators.
- c) The rising tide of cybercrime may be likened to the Cold War arms race – both sides spend time and money trying to outwit the other, but the spiral of measures, counter-measures and counter-counter-measures tends to continue so long as there is motivation and reward. On-line gambling offers governments an opportunity to assess the full spectrum of eCommerce threats and responses seen by operators.

This can provide timely intelligence of value to other sectors as the similar risks may apply to all forms of eCommerce.

- d) The vulnerability of on-line gambling to attack or abuse (by management, staff or consumers) is increased by the separation of the trading parties and the volume of transactions. However automated, high volume, low margin trading is becoming typical of many sectors, so new assurance methods are of general relevance.

Formal ICT Risk Management and ICT Internal Audit seem highly appropriate requirements to apply to the on-line gambling sector in future, whether these functions are insourced, outsourced or co-sourced.

The choice of payment method may be a Critical Success Factor for an on-line gambling operator given the universal 'deposit first, play later' business model generally adopted. However, many of the payment methods popular with EU customers are not subject to any ECB regulation. Although the set of payment methods by national market may vary to suit local laws and preferences, each operator effectively commingles funds received from regulated financial institutions with the funds of unregulated pseudo-financial institutions (such as Webmoney). It may be useful to monitor the grossed up flows between alternative payment systems of all forms and the traditional options (which are already monitored by ECB) to assess if the value exchanged is any threat to more general financial stability or credibility.

FINANCIAL

On-line gambling operators usually report according to well established accounting policies, as required by their External Auditors, Regulators or Stock Market listing rules. Key metrics – such as liability to asset ratios and earnings before tax – are used by third parties to judge the soundness of the operation, but are derived from internal data sources.

It ought to be, but is not, a matter of the highest regulatory concern that the sources and reporting mechanisms of these significant internal metrics are rarely audited in detail - even in the most stringent regulatory regimes. Many operators export their accounting data monthly from bespoke gambling system software. Often the interface used between the on-line gambling system and the external accounting ledgers is a text file which is vulnerable to accidental or deliberate amendment prior to import. Where there is no real-time linkage between the on-line gambling system and the accounting ledgers, adjustments in either may cause a discontinuity, adding to the general confusion.

The low level accounting policies underlying many on-line gambling operations often lack clarity or review. For example, definitions of 'revenue' and 'turnover' are subject to wide variations. Some on-line gambling systems lack double entry transactions so that a database level change may alter the balance owed to a customer without any discernible impact. Systems exist which do not segregate balances owed for real-money transactions from those relating to bonus money (funds that cannot be withdrawn before being risked

and won a set number of times) making it difficult to report player liabilities. Many systems handle multiple currencies yet only apply exchange rate amendments at the end of the monthly accounting period so the financial risk carried is not known in the interim.

The timing of a change to accounting policy can add or subtract millions from the balance sheet of an operator. Arbitrary financial allocations (such as what percentage of bonuses to recognise as liability or which proportion of income to credit per national market) can skew the costs or revenues of the operation significantly. The financial results reported to investors, to players and to regulators may reflect different views.

Given that regulated on-line gambling operators are required to maintain two sets of bank accounts (their own and the 'Client Accounts' holding player funds) there is a necessary process of 'profit taking' where funds earned from player losses are moved from the appropriate 'Client Account' to the operators' own account. It is rare to find this key process formalised or automated. The unpredictable cashflow arising from player activity, combined with an understandable wish to minimise exchange rate costs, leads many operators to apply a 'just in time' profit-taking approach. Typically funds are harvested from the players' accounts based on what surplus is evident or what operator expenses are falling due. Regulators should examine controls around this process and may consider it appropriate to mandate related reports or audit trails.

Related to the above observation is the salient issue that on-line gambling is a 24x7 business and few if any operators apply any 'End of Day' function to reckon or report their financial position in near real-time to the Regulator. In this design aspect, on-line gambling differs markedly from the banking sector where each bank is required to notify the relevant financial services and central bank authorities of its credit worthiness on a daily basis. Banking systems have evolved to allow 24x7 operations whilst still crystallising (or estimating based on clearly defined criteria) their liabilities and assets as at each End of Day. This would appear to be a core requirement of any comprehensive Control System for the on-line gambling sector in the future. Most operators have internal reporting that is intended to perform this function for commercial reasons, but few Regulators have access to such intelligence. Regulators could specify an audited procedure for reporting assets and liabilities daily in collaboration with the industry – if so, this requirement could replace the practice of segregating player funds from operator funds (which is no longer effective as a control given the number of payment aggregators or payment service providers typically involved today).

Detailed reconciliation of the on-line gambling system database balances with the accounting ledgers and with the relevant player accounts/payment service provider fund balances is rarely performed because of the difficulties presented (which are complicated further by exchange rate fluctuations). Whilst operators are in growth, there appears no pressing need for such a control, but if their fortunes begin to decline, such a control may be necessary to detect when the operator becomes insolvent.

It is not unusual for the cumulative effect of minor errors, routine adjustments or accounting policy assumptions to have a significant impact on the bottom line profitability leading to External Auditors making adjustments of many millions.

It is alarming to note that the lack of reliable data for on-line gambling means that any available data is granted elevated credibility. For example, forecasts made in 2000 on the size of the on-line gambling market in 2015 are still quoted as reliable just because they appeared in a Merrill Lynch report. The report has not been updated since 2000, yet the speculative forecasts made are still quoted in 2011, although rarely with any indication of the reference date. There can be few other industries that relieve as heavily on journalism and conferences (corporate marketing) to drive investment decisions.

CONCLUSION

All the points above are offered freely to the authors of the Green Paper in order to extend the scope of the consultation beyond the 51 questions asked. My observations are based on over a decade of co-operation with regulated on-line gambling operators from whom I have learnt a great deal and for whom I have sympathy given the regulatory uncertainty and commercial challenges that they face.

It is vital that the relevance of ICT best practice is appreciated and appropriate control objectives adopted (such as ‘segregation of duties’ to prevent all technical roles being concentrated in one person without monitoring, application of ‘need to know’ principles in access control, impartial and informed risk assessment, effective ‘right of audit’ provision for outsourced duties, etc).

It is my view that on-line gambling is not inherently more risky or more subversive than traditional gambling, but that it requires a different approach to regulation. Far too much effort has been applied in extending traditional controls into this new sector rather than to working with the operators to gain insight that can allow effective and acceptable regulation in the interests of all parties by harnessing the power of ICT.

Better regulation of on-line gambling is in the interests of the commercial operators, the authorities that license them, the economies concerned and society as a whole. It is surely very clear from the comments above that there are very significant gaps in present regulatory approaches – much of the effort applied simply ‘misses the point’.

This means that the honest on-line gambling operator is largely wasting his time in being regulated at all and, meanwhile, the public is not actually being protected from unscrupulous or downright criminal activities. Indeed, the current state of regulation could even encourage the unscrupulous to seek licensing, thereby gaining official ‘endorsement’ for their businesses and making it potentially easier to find victims for their criminal enterprises!

These 11 pages are submitted via e-mail to: MARKT-GAMBLING@ec.europa.eu – please confirm receipt.