DO UK E-MONEY AND PAYMENT SERVICES FIRMS HOLD SAFEGUARDED FUNDS ON TRUST?

The High Court has recently held (in *Re ipagoo*) that the customer funds of an insolvent UK authorised electronic money firm are not held on trust for customers. This conflicts with an earlier High Court decision (in *Re Supercapital*) which held that customer funds of an insolvent UK authorised payment services firm were held on trust and FCA guidance stating that both e-money and payment services firms hold their customer funds on trust. The recent court decision gave a broad application to the statutory priority claims of customers in the insolvency of the e-money firm. However, the difference of view on the characterisation of customers' rights creates uncertainties for e-money and payment services firms.

What do the UK regulations say?

The Electronic Money Regulations 2011 (EMRs) and the Payment Services Regulations 2017 (PSRs) adopt substantially the same approach to the safeguarding of customer funds. They require UK authorised e-money and payment services firms to segregate funds received from customers in exchange for the issue of electronic money or for the execution of payment transactions (relevant funds) from the firm's own money, unless the relevant funds are covered by a qualifying insurance policy or guarantee (reg 21 EMRs and reg 24 PSRs).

Under the regulations, the firm must hold relevant funds in a separate account with an authorised bank or the Bank of England or in the form of low risk assets held in a separate account with an authorised custodian. The account must be in the firm's name but "[n]o person other than the [firm] may have any interest in or right over relevant funds or the relevant assets" except as provided in the regulations. The account must be designated to show that it is being used for safeguarding relevant funds or assets and may not be used for other purposes except as provided in the regulations.

The regulations provide that, in the event of the insolvency of the firm, the segregated funds or assets and the proceeds of any insurance policy or guarantee are treated as a separate asset pool and "the claims of [electronic money holders or payment services users] are to be paid from the asset pool in priority to all other creditors" of the firm, subject to deduction of the costs of distribution (reg 24 EMRs and reg 23 PSRs).

This regime is different from the regime under the Financial Services and Markets Act (FSMA) for authorised firms holding client money. FSMA and FCA rules explicitly provide that authorised firms hold client money on a statutory trust for clients (s 137B FSMA and CASS 7.17 in the FCA Client Assets sourcebook). Authorised firms must segregate client money in bank accounts which are separate from their own accounts, and the statutory trust also applies, from the time of receipt, to money required to be treated as client money which can be identified as being held in the firm's own accounts (*Re Lehman Brothers International (Europe) (in administration)* [2012] UKSC 6).

What did the court decide in *Re Supercapital*?

In June 2020, the High Court issued its judgment in *Re Supercapital* Ltd [2020] EWHC 1685 (Ch). The court concluded that the safeguarding requirements of the PSRs created a statutory trust over relevant funds held by an insolvent payment services firm. The court stated that "[a]ll the characteristics for such a trust being in existence are present", it being important that the PSRs require the segregation of funds received right from inception, ensure that the funds are identifiable, prohibit the firm using the funds in its own business and ensure that the funds are only available to beneficiaries in an insolvency (at para 10).

What does the FCA guidance say?

Following the decision in *Re Supercapital*, the FCA finalised its temporary guidance stating that the EMRs and PSRs both "implicitly give e-money holders and payment service users a beneficial interest in the funds or assets held by the firm in the safeguarding account" and, accordingly, that it considers that "a firm holds these funds on trust for its customers" (para 1.8, *Coronavirus and safeguarding customers' funds: additional guidance for payment and e-money firms*, 9 July 2020).

The FCA has also stated that each e-money or payment services firm "should have an acknowledgment or otherwise be able to demonstrate that the authorised credit institution or authorised custodian has no rights ... over funds or assets in that account" (para 10.40, *Payment Services and Electronic Money – Our Approach; The FCA's role under the Payment Services Regulations 2017 and the Electronic Money Regulations 2011*, June 2019, version 4).

The July 2020 temporary guidance goes on to state that "the acknowledgment should be in the form of a letter (see Annex 1 for an example)" and "must make clear that the funds in the safeguarding account(s) are held for the benefit of the firm's customers" (para 1.10). The form of acknowledgment letter in the Annex to that guidance includes the statement that the firm "hold[s] all [money/assets] standing to the credit of the Safeguarding Account in [the firm's] capacity as trustee under the laws applicable to [the firm]".

Since then the FCA has consulted on amending its safeguarding and prudential risk management guidance by making the July 2020 temporary guidance permanent (*Changes to the SCA-RTS and to the guidance in 'Payment Services and Electronic Money – Our Approach' and the Perimeter Guidance Manual*, CP21/3, January 2021). The FCA's recent guidance to insolvency practitioners also states that both e-money and payment services firms that safeguard using the segregation method hold safeguarded funds on trust (para 60, *Guidance for insolvency practitioners on how to approach regulated firms*, FG 21/4, May 2021).

What has the court now decided?

In *Re ipagoo LLP* (*in administration*) [2021] EWHC 2163 (Ch), the High Court concluded that the safeguarding requirements under the EMRs do not create a trust over the relevant funds and other assets constituting the asset pool of an insolvent e-money firm. The judge disagreed with the FCA's submissions and held that "[t]here is no basis for implying a trust (nor, for that matter, a charge)" and that "the imposition of a trust or charge would at best duplicate Reg 24 [of the EMRs], and at worst conflict with it" (at para 49). Instead, the EMRs require payment of the relevant funds in priority to any other payments which would otherwise be required to be made on the firm's insolvency, "[overriding] the priority rules which would otherwise apply to the distribution of assets upon the [firm's] insolvency" (at para 51).

The court also considered whether customers had priority rights in relation to relevant funds which should have been – but were not - segregated in accordance with the EMRs. The judge concluded that the EMRs must, as a result of the EU Directive which they originally implemented, be interpreted as "giving the same level of protection to Relevant Funds whether or not the EMI had complied with Regs 20-22 [of the EMRs]" (at para 52).

As a result, "it is necessary to treat the Asset Pool in Reg 24 [of the EMRs] as including a sum equal to all Relevant Funds which ought to have been, but have not been, safeguarded" (at para 54). The judge explained that "the protection does not extend to the actual Relevant Funds which have not been safeguarded, but extends to an equivalent sum" (at para 53). Instead, the insolvency official responsible for distributing the assets of the insolvent [firm] must calculate the amount of any relevant funds which should have been, but were not, safeguarded by the [firm] as required by the EMRs and "a sum equal to those Relevant Funds assets (sic) must be added to the Asset Pool and distributed in accordance with Reg 24 in priority to any other distributions" (at para 55).

The court noted the earlier decision in *Re Supercapital* holding that the EMRs did create a statutory trust over relevant funds held by an insolvent payment services firm. That decision was not binding on the court in *Re ipagoo* and the court commented that "it appears that [the judge in *Re Supercapital*] did not have the benefit of hearing submissions to the contrary" (at para 41).

Is a priority claim different from rights under a trust?

Characterising the rights of customers as priority claims in insolvency may result in outcomes for the e-money or payment services firm, and its customers and banks, that are different from the outcomes if those rights were regarded as rights under a trust. For example:

- If customers only have a priority claim in insolvency, the firm may not be subject to the fiduciary duties that would apply to it if it were a trustee of relevant funds (although a trustee may be able to limit its obligations through its terms of business).

- The decision in *Re ipagoo* suggests that customers have a priority claim for unsegregated relevant funds against the general assets of an insolvent firm even if those assets are not in any way derived from funds received from customers. In contrast, rights under a trust, even if the trust applies to funds from the time of receipt, may only extend to assets of the insolvent firm that are identifiable as derived from those funds.

- Customers that have a priority claim in insolvency may not have the tracing or other remedies against third parties that might be available to the beneficiaries of a trust where relevant funds are wrongly paid away by the firm.

- The characterisation of customers' rights as priority rights in insolvency rather than rights under a trust might be relevant to the firm's accounting treatment of the balances on the account.

In addition, treating the rights of customers as claims under a trust might be more likely to suggest that customers have 'look-through' rights to compensation from the Financial Services Compensation Scheme (FSCS) if the bank holding relevant funds fails and the customers are regarded as 'absolutely entitled' to the funds in the account (rule 6.10 of the Depositor Protection part of the PRA rules). 'Look-through' rights would also have implications for a bank holding the funds in a safeguarding account. The bank may be required to mark the account and to include the account in its 'exclusions view' when complying with its single customer view requirements under the Depositor Protection part of the PRA rules. It may also be required to include the accounts when calculating its tariff base for the funding of the FSCS scheme under those rules or (for a UK branches of a non-UK bank) when considering the PRA's policies on subsidiarisation of branches where the potential liability to the FSCS in relation to the branch's covered deposits exceeds £500 million (para 6.16 SS5/21 I*nternational banks: The PRA's approach to branch and subsidiary supervision*). However, even though the FCA guidance states that firms hold relevant funds on trust, the FCA has also stated that FSCS protection does not apply to e-money and payment services firms and that they must not suggest that their customer funds are protected by the FSCS.

What does this mean for e-money and payment services firms?

The differences of view on the characterisation of customers' rights leaves e-money and payment services firms in an unsatisfactory position until there is further guidance from the FCA or clarification of the position through the courts.

Firms may wish to consider how best to reflect the current legal position in the acknowledgements they obtain from banks and custodians in the future. Firms may also wish to consider the terms of existing acknowledgements that refer to a trust. The decision in *Re ipagoo* did not discuss the impact of any reference to a trust in the terms of any letters of acknowledgement exchanged by the insolvent firm with the bank holding the segregated funds.

In addition, firms may wish to review their communications with customers about how their money is protected to ensure that they appropriately reflect the current legal position. The FCA's rules require firms to ensure, among other things, that their financial promotions are accurate, do not emphasise any potential benefits of a payment service or electronic money product without also giving a fair and prominent indication of any relevant risks, are sufficient for, and presented in a way that is likely to be understood by, the average member of the group to whom it is directed, or by whom it is likely to be received, and do not disguise, diminish or obscure important information, statements or warnings (BCOBS 2.3.1R). In May 2021, the FCA issued a letter to CEOs of e-money firms asking them to write to their customers to remind them of how their money is protected through safeguarding and that FSCS protection does not apply to their funds.

What next?

The FCA may revisit its guidance in the light of the court's decision in *Re ipagoo* or there may be further clarification of the position through the courts, as the decision may be appealed.

In addition, there may be legislative changes that affect the position. In April 2021, HM Treasury published its feedback statement on the results of its consultation on insolvency changes for payment and e-money firms launched in December 2020. The government proposed to improve the insolvency protection for customers by introducing a new special administration regime for payment and e-money firms and giving the FCA the same rights to participate and protect consumers in an insolvency process as it has for other FCA supervised firms. However, the government's proposals assumed that the decision in *Re Supercapital* correctly reflected the state of the law and thus may need to be developed in response to the decision in *Re ipagoo*.

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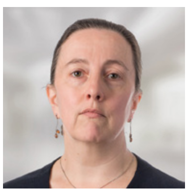

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