Feature

KEY POINTS

- The *Supercapital* decision which established a trust under the Payment Services Regulations 2017 (PSRs), provided few details regarding that trust.
- Accordingly, it leaves undecided questions of the extent and scope of the trust and the nature of the trustee duties.
- The trust classification will also have unintended consequences, for example by potentially adding Financial Services Compensation Scheme (FSCS) protection to accounts held by payment institutions (PIs) with credit institutions and allowing equitable remedies to be sought for breach of trust.

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Unfinished business? The payment services safeguarding rules after *Supercapital*

In the recent *Supercapital* decision, the High Court found that the Payment Services Regulations 2017 (PSRs) created a trust over customer assets. This trust relationship addresses certain gaps in the safeguarding rules under the PSRs, but raises additional questions and will have unintended consequences – not least of which, it now appears that funds held by a non-bank payment institution with a credit institution may be subject to Financial Services Compensation Scheme (FSCS) protection in the event of insolvency of the credit institution. This article highlights some of the additional questions and unintended consequences raised by *Supercapital* and argues that legislative intervention is required to update the PSR safeguarding regime.

The failure of Lehman Brothers was a watershed moment in recent economic history. Its insolvency was the collapse that launched a thousand legal claims and demonstrated the inadequacy of existing insolvency laws to deal with complex bank resolution. It unleashed a wave of legal reform to reduce the risk posed by banks' insolvency, to end the era of banks being "too big to fail" and most notably saw the introduction of new specialist regimes for bank and investment bank insolvencies at UK and EU level. However these post-Lehman reforms have not extended to non-bank payment institutions (PIs) and electronic money institutions (EMIs). With these firms' rapid growth and increasing importance to the FinTech ecosystem, coupled with the pressures of the current economic climate and the high profile issues around Wirecard, many are starting to wonder whether the existing regulatory framework for PIs and EMIs is fit for purpose.

The safeguarding and insolvency regimes under the Payment Services Regulations 2017 (PSRs) and the Electronic Money Regulations 2011 (EMRs) leave a number of questions unanswered. The rules, unlike the more sophisticated regime in the banking and investment services sectors (particularly as it has developed post-Lehman), are light on detail, leaving too much room for interpretation by the regulator and by the industry thereby causing legal uncertainty.

Against this backdrop, the courts have recently stepped in to plug the policy gap. In the recent decision in *In Re Supercapital* [2020] EWHC 1685 (Ch) (*Supercapital*), the court clarified one area in which there has not, hitherto, been universal agreement by the legal community, by holding that the safeguarding arrangements under the PSRs establish a trust in favour of payment service users. The FCA has already referenced the *Supercapital* judgment in its temporary guidance on safeguarding, illustrating the importance of the decision to the market at large. In this article, we consider the court's decision and assess some of its potential implications.[1]

SAFEGUARDING RULES FOR PIS

The PSRs, which implement the EU's Second Payment Services Directive (EU) 2015/2366 (PSD2) into UK law, contain specific provisions as to how customer funds are to be treated by PIs on a day-to-day basis, and also address the position in respect of a PI's insolvency. Under the PSRs, PIs are required to safeguard "relevant funds" in accordance with reg 23 (which implements Art 10 of PSD2). "Relevant funds" are defined in reg 23(1) as:

- sums received from, or for the benefit of, a payment service user for the execution of a payment transaction; and
- sums received from a payment service provider for the execution of a payment transaction on behalf of a payment service user.

PIs are given a choice of two approaches as to how to safeguard relevant funds – the "segregation method" or the "insurance method". The *Supercapital* decision is concerned exclusively with the segregation method. Under this method, "relevant funds" must be kept separate from the funds of the PI – with Art 10 of PSD2 further providing that there must be no comingling "at any time" between relevant funds and funds belonging to any other legal or natural person other than payment service users on whose behalf the funds are held.

Where "relevant funds" continue to be held by the PI on the close of business on the day after those funds were received by the PI, it must deposit them into a "safeguarding account" with a credit institution. This safeguarding account must be designated in a manner which indicates that it is a safeguarding account and should only hold "relevant funds". No person other than the PI may have an interest in those "relevant funds", other than as specifically provided for under the PSRs. In order to meet this requirement, the FCA suggested in its "Payment Services and Electronic Money – Our Approach"[2] (Approach Document) that a PI should obtain an acknowledgement letter from the credit institution holding the safeguarding account.

On an insolvency event in respect of the PI, relevant funds in a segregated account and relevant funds in a safeguarding account comprise a distinct "asset pool". The PSRs provide that the claims of payment service users are to be paid from the "asset pool" in priority to all other creditors. Until such time as the claims of payment service users have been paid, no right of set-off or security right may be exercised in respect of that asset pool (except for the right of set off in respect of fees and expenses that relate to operating the safeguarding account).

This segregation and safeguarding arrangement has created some debate as to the nature of the rights created by the PSRs in favour of customers. Unlike client money held by authorised firms under the Financial Services and Markets Act 2000 (FSMA), which expressly provides that the FCA may make rules pursuant to which client monies are to be held subject to a statutory trust (in England and Wales), the language of the PSRs does not expressly refer to relevant funds being held on trust for customers. Accordingly, although the framework set up by the PSRs is, in many respects, consistent with trust law concepts – the requirement of segregation of funds, remoteness from the PI's estate in an insolvency, etc – the different approach taken in the PSRs when compared with the position under FSMA had given rise to questions about whether a trust exists.

SUPERCAPITAL

In *Supercapital*, the High Court found that the PSRs created a statutory trust in favour of payment service users. In reaching its conclusion the court relied upon the decision of the Court of Appeal in *Lehman Brothers International (Europe) (in administration) v CRC Credit Fund Ltd* [2010] EWCA Civ 917 (*LBIE*) (which was later confirmed by the Supreme Court in *Re Lehman Brothers International (Europe) (In Administration)* [2012] UKSC 6 (*LBIE No 2*)). *LBIE* related to the application of the safeguarding rules under CASS 7 and FSMA and in particular to the scope of the statutory trust created under those rules.

The court in *Supercapital* referred to the following provisions of the PSRs as being indicative of a statutory trust:

- the term "relevant funds" is focused on identifying funds received for the "benefit of third parties";
- the fact that funds are required to be segregated is inconsistent with a "debtor/creditor" relationship;
- PIs are required to maintain records of the segregated relevant funds which is inconsistent with such funds being treated as "company funds";
- no other person is permitted to have an interest in the safeguarding account other than the PI. This indicates that funds should be treated as separate from funds which belong to the company; and
- payment service users have a priority claim against the segregated account.

Unfortunately, as *Supercapital* was an insolvency case, there was little additional consideration given as to what this trust meant in practice for PIs and provides little guidance on related trust issues.

QUESTIONS ARISING FROM *SUPERCAPITAL*

The court in *Supercapital* relied heavily upon the *LBIE* judgment in coming to its conclusion as to the trust under the PSRs. Yet *LBIE* involved interpretation of a statutory trust under CASS. The CASS regime differs markedly from the PSRs in many respects and so *LBIE* does not provide a wholesale answer to how trust concepts are to be applied in respect of PIs.

Unresolved Issue 1: "Relevant funds"

The safeguarding rules in the PSRs require PIs to safeguard and segregate "relevant funds". However, there is some ambiguity as to which funds are "relevant funds", and when funds cease to be "relevant funds" under the PSRs.

It is not always clear which funds received in relation to a payment service are "relevant funds". In the context of card transactions, acquirers will often receive bulk, net payments from the card scheme to settle with their merchants. At times, this will involve funds which the PI itself is entitled to (for example, fees payable to the acquirer, or amounts due to the acquirer where the acquirer has settled with a merchant before receipt of funds from the scheme). There is a question as to whether these unallocated, comingled funds received by the PI should be treated as "relevant funds" or not. In its consultation on safeguarding (released in May 2020) the FCA took the view that "unallocated funds" were not "relevant funds". After extensive industry feedback, the FCA reversed its position, illustrating the difficulty that may arise when identifying "relevant funds" as distinct from other funds received by PIs. Where these relevant funds form the basis of the trust, it can be difficult to identify the subject matter of the trust.

There is also a question of when funds cease to be "relevant funds". In the context of a card transaction, an issuer will hold customer funds on behalf of the cardholder. Once the cardholder has used their card in a store and the transaction has been authorised, the merchant no longer has a claim against the cardholder (and instead acquires a claim against the acquirer) and the cardholder itself is no longer entitled to the funds. Yet as those funds are still held with the issuer pending settlement, the FCA has argued in its Approach Document that the funds remain "relevant funds" until they have been transferred from the issuer. The reference in the definition of "relevant funds" to funds received "for the execution of a payment transaction" has been suggested by some to indicate that funds remain relevant funds until the transaction has been settled (which would ensure there is no gap in safeguarding between settlement). However, this approach is sometimes difficult to reconcile with the legal relationships that underpin settlement and clearing via payment schemes and, as the legislation is not clear on the point, this remains a subject of debate.

The lack of clarity around the scope of "relevant funds" in the PSRs leaves open questions as to how to apply the safeguarding rules and the scope of the trust under the PSRs. This raises difficulties in applying the safeguarding principles on a day to day basis, which could result in PIs miscalculating the amount of "relevant funds" they are required to hold.

Unresolved Issue 2: Comingling

While *Supercapital* is clear that the PSRs create a trust, it is not always clear which assets are the subject of this trust. It is a requirement of trust law that there must be "certainty of subject matter" (amongst others), yet this requirement is not a particular focus of the judgment in *Supercapital*.

In *LBIE* and *LBIE No 2*, the court found that the "trust" under CASS extended to all client monies, whether segregated or not and also applied with respect to clients whose funds had not actually been segregated (as at the last internal reconciliation). In coming to this conclusion, the court applied the concept of a "final reconciliation" to determine customer entitlements as at the time that a "primary pooling event" occurred under CASS. To reach this conclusion, the court relied upon specific provisions of CASS, which are not replicated in the PSRs. Without this express wording, it is unclear which assets will be subject to the statutory trust under the PSRs.

An argument could be made that the trust is over the "asset pool" defined in reg 23(18), as this is the assets against which a claim would be made in respect of an insolvency of the PI. However, reg 23(14) acknowledges that, in the event that the claims of payment service users are satisfied, the remainder of the asset pool should be applied to "other creditors". This may be viewed as contrary to ordinary trust principles, where residual trust assets are ordinarily split amongst beneficiaries of the trust (albeit with certain exemptions, such as for trustee or administrator liens). The courts in *LBIE* upheld the CASS trust, despite the fact that third parties could have had been entitled to assets held in the client money accounts (in the event of excess funds being held in those accounts). This can be explained, as the CASS trust was not over the accounts, but instead was over "client money" regardless of the account in which such money is held. Accordingly, if the trust assets are seen to be the "asset pool" *LBIE* does not provide an explanation as to how to reconcile the principle that trust assets should not be applied to the general creditors of the trustee (absent some greater claim of the trustee to those assets – for example through a trustee's lien), with the wording of reg 23(14).

Limiting the trust to only those assets in the" asset pool" (defined in the PSRs as those funds actually segregated/ safeguarded) would also not achieve the policy aims as set out in PSD2. Article 10(1) of PSD2 provides that "funds shall not be comingled at any time with the funds of any natural or legal person other than payment service users on whose behalf the funds are held" and that those funds should be "insulated in accordance with national law in the interest of the payment service users against the claims of other creditors". Where the subject matter of the trust is only those assets which have been actually segregated, this would not appear to cover "relevant funds" which the PI has failed to segregate or safeguard. Applying the purposive reasoning of the court in *LBIE*, limiting the trust to only actually segregated or safeguarded assets would be contrary to the intention of the Directive.

Payment service users would be better protected if, instead, the trust attaches to all "relevant funds" held by the PI regardless of whether they have been segregated. This would be consistent with both the Directive and the reasoning in *LBIE*. In order to give effect to that protection, the PI's insolvency officeholder may need to conduct a "final reconciliation" as envisaged in *LBIE* to ensure that, as at the time of the insolvency event, relevant funds held in the PI's house accounts are (notionally at least) moved to segregated accounts to form part of the asset pool. Absent that sort of reconciliation, it is difficult to square the *LBIE* approach with the wording in reg 23(14) which only grants payment service users priority in respect of funds in the "asset pool". Without the wording in CASS relied upon by the Court of Appeal in LBIE though, it is difficult to determine the legal basis for such a "final reconciliation" under the PSRs. This, combined with the express wording of reg 23(14), create difficulties when applying the "final reconciliation" concept to the PSRs. Nonetheless those difficulties would probably not prove insurmountable to a judge seeking to apply a broad, purposive approach driven by achieving the maximum level of protection for customers.

Unresolved Issue 3: extent of trustee obligations and duties

Trustees are subject to a range of duties and obligations depending on a number of factors including whether the trust is a bare trust, the terms of the trust and the assets of the trust. In concluding that a trust existed under the PSRs, the court did not provide further detail as to the extent of the duties imposed upon PIs as trustees.

The first question this raises is the extent to which the fiduciary duty applies to PIs when providing payment services. On the basis of the reasoning of the court in *Supercapital*, there are arguments that the trustee obligations applicable to PIs could extend to the conduct of their payment services. This is because the core services provided by a PI are not dissimilar to those obligations imposed on a bare trustee – that is, an obligation to securely hold client assets and to deal with those assets (eg by transferring them) in accordance with client instructions. Accordingly, where a PI transfers customer assets (ie executes a payment transaction) other than in accordance with the instructions of the customer, the customer may be able to seek remedies available under the PSRs or equitable relief for breach of trust.

Secondly, trustees are subject to a range of duties, although the extent of their application changes depending on a range of factors. For example, trustees are under a fiduciary duty not to secretly profit from their role as trustees, and not to place themselves in conflict with the beneficiaries except where that is expressly authorised. It is not clear the extent to which PIs will now need to expressly account for (or exclude) these duties in their customer terms, and, if they fail to do so, whether they may be found to be in breach of trust as a result of such failure.

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THE CONSEQUENCES

The court in *Supercapital* was concerned with the distribution of safeguarded assets. However, finding that there is a trust may also have certain other (possibly unintended) consequences, in particular under the Financial Services Compensation Scheme (FSCS) and also in respect of dealings with trust property.

FSCS protection

Deposits held by a PI with a credit institution are not eligible deposits under Depositor Protection (DP) Rule 2.2(4)(d) of the PRA Rulebook. This section excludes from the FSCS deposits made by a "financial institution". PIs/EMIs are "financial institutions" by virtue of the definition provided in Art 4(1)(26) of the Capital Requirements Regulation ((EU) No 575/2013) and Annex I of the Capital Requirements Directive (2013/36/EU). However DP 6.2(5) provides that where the account holder is not absolutely entitled to the eligible deposit, then the person who is "absolutely entitled" to the account is entitled to compensation in respect of the deposit, provided that the other person has been identified or is identifiable. DP 6.10(a) then proceeds to note that a person is absolutely entitled to an eligible deposit where that person is a "beneficiary under a bare trust".

Prior to *Supercapital*, it was unclear as to whether a PI (or EMI) safeguarding account should be treated akin to a trust deposit (and therefore eligible) or whether it should be regarded as the same as any other deposit of the PI/EMI. The EBA in its Opinion on the eligibility of deposits, coverage level and co-operation between deposit guarantee schemes (EBA-Op-2019-10) of August 2019 (and related report) suggested that such accounts should be covered by the DGS but the position in the UK was not entirely clear. On the basis that *Supercapital* establishes a "bare trust", it would appear that the individual payment service users may be able to "look through" the PI/EMI for the purposes of FSCS protection. In such case, payment service users would potentially be able to claim under the FSCS in the event that the credit institution holding the relevant safeguarding and segregated accounts became insolvent. Theoretically the same would also apply in respect of any trust assets held in the house account by the PI as trustee.

Accordingly, the finding of a statutory trust under the PSRs may doubly protect customer funds – firstly in the event of an insolvency of the credit institution through a claim against the FSCS up to the relevant maximum, and secondly in the event of the insolvency of the PI by way of the statutory trust protecting customer assets.

The position that such PI/EMI safeguarding accounts attract FSCS protection would have implications for credit institutions providing safeguarding accounts to PIs/EMIs. These institutions would need to look through the accounts held by the PI/EMI to report the underlying beneficiaries under the exclusions view in DP and may be subject to an increase in the FSCS levy paid in order to include additional amounts referable to these PI/EMI deposits.

Dealings with trust property

The *Supercapital* judgment also has potential implications for persons dealing with the "trust property". Additional remedies apply to beneficiaries for breach of trust. Depending on the scope of the trust (as discussed above) where the trustee does not apply "relevant funds" to a segregation account or safeguarding account, they would arguably be acting in breach of their duty. This may entitle a beneficiary under such arrangements to seek to apply equitable remedies (such as tracing) and could also impact upon recipients of trust property or those assisting in the breach of trust. Where the credit institution holding the trust account has knowingly assisted with the transfer of funds to the house account in breach of trust, they may risk being a constructive trustee of trust property exposing them to potential claims by payment service users.

Finally, as noted by Lady Justice Arden in *LBIE* there are many other "trust rules" which may now apply to the PSR safeguarding regime, but this will need to be considered in light of the statute and the intentions of Parliament. Other consequences of the trust classification may also follow, for example when determining beneficial owners under AML rules.

CONCLUSION

The first iteration of the safeguarding rules contained in the PSRs was prepared in a different era, when the regulation of payment services was new and before the decisions in *LBIE* and post-Lehman reforms. While the insolvency regime for investment firms and credit institutions has changed considerably since the first version of the PSRs, the insolvency regime for PIs has changed very little. During this time the industry has seen rapid growth of many PIs with large amounts of customer funds under their control. While judicial decisions and regulatory intervention can help to plug gaps in the legislative framework, this approach gives rise to issues of uncertainty that can be negative both for firms and their customers, and it is legitimate to ask whether it is time to revisit the framework with a view to providing greater clarity. Until this happens, there will continue to be unfinished business. ■

1 This article considers the application of the safeguarding rules under reg 23(5)-(11) of the PSRs in light of *Supercapital*. The FCA has clarified that it considers that *Supercapital* also applies to electronic money institutions under the EMRs. While safeguarding under the EMRs is not considered in this article, slight differences may arise, particularly in light of the different definitions of "relevant funds" between the EMRs and the PSRs. This article does not consider the position where funds are held in an account with a designated system/Bank of England, nor where those funds are invested in investable assets under reg 23(6)(b).

2 Version 4 dated June 2019.

Further Reading:

- How safe is the pound in your phone? Lessons from Wirecard (2020) 10 JIBFL 676.
- PSD2 and the safeguarding of clients' funds: a comparative analysis with respect to funds of payment service users in the Netherlands and Brazil (2020) 9 JIBFL 620.
- LexisPSL: Practice Note: The regulation of payment services providers – essentials.