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Response to the FCA's Consultation Paper CP24/20 *Changes to the safeguarding regime for payments and e-money firms*

Introduction

I welcome the opportunity to provide my views on the FCA's planned changes to the legal safeguarding regime for payment and e-money firms ('payment firms'). I will focus my response on question 16 of the consultation, which concerns the imposition of a statutory trust over funds that have been received by payment firms from their customers ('relevant funds').

The trust question has by now an almost five-year history. It began with the FCA's consultation in May 2020 *Coronavirus and Safeguarding Customers' Funds: Proposed Guidance for Payment Firms*, where the FCA first stated that payment firms hold relevant funds or assets in their safeguarding account as trustees under the Electronic Money Regulations 2011 ('EMRs') and the Payment Services Regulations 2017 ('PSRs'). This understanding was first confirmed, then disputed by the courts, the most recent conclusion of the Court of Appeal in *Re Ipagoo LLP (In Administration)* [2022] EWCA Civ 302 being that no such trust is created by the legislation. In an article[1] published later in 2022, I set out why I thought the court was right, and the FCA had been wrong, on the trust question.

Since then, the FCA have been given the power under section 137B(1) of the Financial Services and Markets Act 2000 ('FISMA') to require relevant funds to be held on trust by payment firms for their

[1] J. Jacques (2022) 'E-money and Trusts: A Property Analysis,' *Law Quarterly Review* 138(Oct), 605-623.

customers. The rules currently consulted on will implement such a trust once the relevant provisions in the EMRs and PSRs have been repealed and the new rules incorporated into the FCA Handbook. At that point, the ruling in *Re Ipagoo* will no longer apply.

The approach of the FCA has thus been to create the legal property relations through its powers that it thinks should be – but are currently not – in place between payment firms and their customers. This step may be justified from the point of view of consumer protection on the insolvency of a payment firm, but it fundamentally alters the legal basis for the financial services offered, and the consultation does not address the potential wider legal consequences of this change.

My response below will describe what I think some of these legal consequences might be. It will focus on e-money, which is most impacted by the proposed change.

16. Do you agree that a statutory trust is the best replacement for the safeguarding regime in the EMRs and PSRs? If not, please explain why.

According to its legal definition, e-money is "stored monetary value as represented by a claim on the electronic money issuer which is issued on receipt of funds for the purpose of making payment transactions" (Regulation 2(1) EMRs). The definition of e-money as "stored monetary value," together with the requirement for e-money to be issued "at par value" (Regulation 39(a) EMRs) means that its issuance involves the creation of monetary value that is equivalent to, but separate from, the funds with which customers pay for the e-money (i.e., the relevant funds). The link between the two items of value is the chose in action that e-money customers receive, requiring issuers to reverse the exchange on request.

Accordingly, e-money can be held, lost, stolen, transferred or destroyed without thereby affecting either the legal or factual status of the relevant funds. Conversely, relevant funds can be held, lost, stolen, transferred or destroyed without thereby affecting the e-money, which continues to hold its value and act as a means of payment (an issuer remains liable to redeem e-money even when it no longer has the underlying relevant funds).

Since its development in the late 1990s, the function of e-money has been as an "electronic surrogate for coins and banknotes."[2] While its status as 'money' is debatable, it constitutes an online means of payment that is in practice used like money and accepted in satisfaction of customers' legal obligations under contracts with third parties. A good case can be made for the legal categorisation of e-money as personal property in the proposed third category of personal property, although the Law Commission has declined to take a view on this "because this is a significant area of investigation."[3]

The fact that e-money is both equivalent in value and separate from relevant funds, is legally significant in various respects. I will briefly highlight what are perhaps the most important four:

i) On the issuance of e-money, customers' property rights in the funds with which they pay for the e-money are transferred to the e-money itself, which they can then spend or transfer to others online in satisfaction of their personal contractual obligations. The

[2] Directive 2000/46 on the taking up, pursuit of and prudential supervision of the business of electronic money institutions [2000] OJ L275/39, recital 7; Directive 2009/110 on the taking up, pursuit and prudential supervision of the business of electronic money institutions [2009] OJ L267/7, recital 13.

[3] Law Commission (2024) *Digital assets as personal property: Supplemental report and draft Bill*, para. 3.55, p. 46.

issuance of e-money thus constitutes one side of a purchase contract, in which customers buy e-money in exchange for funds. To say, as the proposed rules do (see, for example, CASS 15.3.1G(2)), and as the statutory trust effectively achieves, that customers also remain the equitable beneficial owners of the money with which they pay for the e-money, would undo the legal nature of issuance as a transfer of ownership from one store of value to another. This would not only affect the legal understanding of issuance but also the legal positions of the parties offering or accepting e-money in payment (see ii) below), the role that e-money plays in payment services (see iii) below) and the general civil and criminal treatment of the involved parties and events (see iv) below).

ii) In order for e-money to be able to successfully act as a means of payment, those who are accepting it (online merchants or other third parties) must be sure that any e-money offered to them in payment represents value. This value is only created through the transfer of the value in the customer's funds to the e-money in the exchange transaction that is the purchase of e-money. If customers no longer purchase anything when they purchase e-money because they retain ownership rights in the funds with which they 'buy' e-money, then merchants cannot be sure that they are accepting anything of value at all. The obvious conclusion for merchants would be to demand payment using the underlying funds in the first place, rendering e-money as a means of payment redundant.

iii) Understood as a separate store of monetary value, e-money allows a payment service to be offered in its respect. Once e-money is no longer seen as a separate store of value, what customers are getting is itself merely a payment service in relation to the funds they hand over to the issuer. These relevant funds, however, are not transferred to merchants or third parties in payment, remaining instead as deposits in the safeguarding account (or, where insurance is used as the safeguarding method, are transferred to third parties entirely unrelated to the customer). A payment service can therefore not be said to be offered in relation to the relevant funds, and it becomes uncertain what value is the object of the payment service.

iv) Under current law, the rights and liabilities of the parties in relation to both relevant funds and e-money are clear. On the one hand, e-money issuers are the absolute owners of relevant funds, which they must safeguard either through segregation or insurance but can otherwise use for their own benefit. Theft or loss of safeguarded funds does not extinguish an issuer's liability towards its customers to redeem any e-money they are presented with, and it is only on the insolvency of the issuer that customers' rights of redemption crystallise into rights in respect of the asset pool. On the other hand, e-money customers are the absolute owners of the e-money, in respect of which – and only in respect of which, given they have exchanged their property rights in the relevant funds for e-money of an equivalent value – they can vindicate their property rights vis-à-vis third parties. Should customers be found to have themselves committed financial crimes, it is the e-money which become the proceeds of crime, with the underlying funds untainted until the redemption/extinguishment of the associated e-money.
The loss of separation between e-money and relevant funds is likely to affect this clarity, with legal uncertainty potentially arising in various civil and criminal areas of law. For example, issuers could disclaim any further liability to customers when relevant funds are lost or stolen (as is indeed a normal feature of trusts under general law), or customers could assert their ownership rights in the underlying funds when confronted with the loss

or theft of e-money, which is much more quickly transferred and withdrawn than relevant funds. Contractual disputes about the provision of goods or services paid for with e-money could be abandoned in favour of the assertion of ownership rights in the relevant funds, while issuers' fiduciary duties could be litigated in situation in which issuers redeem e-money to parties whose ownership of e-money did not stem from a legally valid transfer of e-money. Law enforcement could attribute criminal liability to banks or other third parties dealing with relevant funds instead of those parties dealing with tainted e-money.

It should be clear from even these sketchy remarks that the legal change which the FCA is proposing in its consultation by stipulating that relevant funds are held on trust for customers is far from legally innocuous. E-money occupies a distinct legal position when compared to other financial services such as deposits or investments, and any change to this position should be carefully considered as to all its potential effects, whether these occur in the law of payments, trusts law, contract law or criminal law. While consumer protection on insolvency is a worthy objective, the current proposals arguably fall short of this careful consideration.