Issuing & Safeguarding of E-money – some interesting cross-border issues in Europe and the potential implications of the Lehman Bros case

Overview: European payments companies must take careful measures to meet their legal obligations given the differences in transposition and interpretation of the underlying European Directives and the variety of relevant Member State laws. EMI's must undertake careful and continuous money management processes, this should include a Host State country and legal risk assessment and continuing review. Until the European e-money sector becomes more mature, EMI's are encouraged to sweep regularly from any Host State accounts to their Home State since this provides the best practical guarantee for e-money holder funds.

This guidance note highlights some complexities and potential deficiencies in current European payment law.

Issuance & Redeemability

When funds are received by an Electronic Money Institution ("EMI") from their clients for the purposes of obtaining e-money from the EMI, it is clear that EMI's must immediately issue (and redeem on request) e-money in accordance with the 2nd E-money Directive E-Money Directive (2009/110/EC) (the "2nd EMD" - for example, see Article 6 of the 2nd EMD). In addition, it is clear that EMIs must also "*safeguard funds that have been received in exchange for e-money that has been issued*". These are known as "relevant funds".

Segregation & Preference

Relevant e-money liabilities must be matched by safeguarded funds to ensure that the e-money client funds are protected. The safeguarding provisions are therefore intended to act as a way of identifying and segregating preferred liabilities from other creditors of an EMI. The effect is that the protection should be in place to defeat other creditors of an EMI (at any time) and in the event of insolvency it should ensure easy ascertainment of a defined pool of secured assets that is available to meet the e-money liabilities in the first instance (i.e. requiring preferential treatment as against other creditors of an EMI).

Structure of the Safeguarding Requirements

EMI's are required to safeguard e-money client funds using one of the statutorily specified methods: by placing them in segregated accounts with suitable credit institutions and naming them as safeguarded accounts; investing them in relevant assets with an authorised custodian; or by putting in place appropriate insurance or guarantees to safeguard the same (Article 7 of 2nd EMD and Article 9 of the Payment Services Directive, Directive 2007/64/ EC. –"PSD"). EMI's are subject to both the PSD and the 2nd EMD in the pursuit of their authorised activities.

However, given the purpose of the safeguarding requirements, EMI's must also maintain a continuing watch over these statutorily mandated methods of protection to ensure that the chosen method (including the chosen bank, custodian or insurer) continues to provide actual protection for the e-money holder liabilities (see e.g. Article 5 and Article 10 of the PSD).

Reconciliation

There is some statutory allowance for a short delay (one business day – see Article 7 of the 2nd E-money Directive and Article 9 of the PSD) in matching e-money liabilities with safeguarded liabilities. However, the e-money liability accrues immediately and this means that monies received by a person acting on behalf of the EMI (such as an agent or distributor), becomes an e-money liability as at the date of transfer of the cash (even before it is received by the EMI) even though a day's grace is permitted for safeguarding the same. In addition, e-money funds received in the form of payment by a payment instrument only have to be safeguarded when they are credited to the institution's payment account or are otherwise made available to the EMI or credit union, subject to maximum delay of five business days after the date on which the e-money has been issued (Article 7 of the 2nd EMD and Article 4 of the PSD). This relates to e-money paid for by a payment instrument such as a credit or debit card.

This statutory allowance for some reconciliation issues between e-money liabilities and safeguarded funds illustrates why in practice there is recognition for the need for an EMI to do regular working reconciliations that are subsequently fully reconciled when all transaction, processing, payments and settlement information is available for the day in question. However, unless there is a statutory allowance for reconciliation delay then,

in addition to the e-money liability which arises upon funds transfer, the EMI must also ensure that it has safeguarded funds based on a worst case scenario of its likely e-money liabilities at any given point (given the reconciliation information known to it) and based on its objective to ensure the safeguarded funds are indeed adequate.

Protecting Funds held with a Credit Institution – Gibraltar and UK

Transposition of the 2nd EMD and the PSD in Gibraltar and the UK has been carefully dealt with to protect safeguarded funds including those held under the credit institution option. The credit institution account must not be used for holding any other funds, and no-one other than the EMI/credit union may have an interest in or right over the funds in it (except an insolvency administrator under certain specified conditions and subject to limitations). This precludes a creditor of an EMI or a financier or counterparty (such as the card schemes, e.g. MasterCard or Visa) from having a charge over e-money holder funds.

Given the requirement not to co-mingle or create a charge or interest under English and Gibraltar law, EMI's must therefore ensure they use a range of funding accounts for their business so as to keep separate e-money liabilities from other funding requirements that are required to offer the e-money services (e.g. pre-funding of amounts to cover funds in flight settlement collateral requirements from the card schemes).

How safe are safeguarded funds? - the European Dimension

Unfortunately the drafting contained within the Directives relating to protection against third party creditors of an EMI has obvious shortcomings, for example:

"they [safeguarded funds] shall be insulated in accordance with national law in the interest of the payment service users against the claims of other creditors of the payment institution, in particular in the event of insolvency" (Article 9, PSD)

The above wording clearly did not intend to protect e-money holder (as a class of payment service user) liabilities only after an event of insolvency and the words "including in the event of insolvency" should have been used instead of "in particular"). However, this highlights the need for careful national transposition to ensure that e-

money liabilities are definitely protected from creditors both in the normal course and after an event of insolvency.

An interesting question arises in relation to the treatment of e-money liabilities that are not held in accordance with the technical safeguarding requirements (or which otherwise fail to be protected, e.g. due to defects in transposition or failure by courts to undertake a purpose interpretation under national Member State law). This issue is all the more pressing since the 2nd EMD and the PSD have not been carefully translated and transposed across Europe (having in mind the different existing legal frameworks in Europe within which the Directives are transposed).

In the absence of careful drafting of the Directive and purposive transposition there remains a significant legal risk for e-money customer funds held in other European Member States. Indeed, and despite the 2nd EMD being a full harmonisation Directive in most respects, evidence exists in some countries (such as Germany and the Netherlands) of significant problems in guaranteeing protection of such safeguarded funds because local law has not been properly adapted to guarantee the protection of safeguarded funds. This could result in execution of a third party attachment order against such funds or those funds not being properly ring-fenced as against other creditors in the event of insolvency of the EMI. In the Netherlands, additional structural measures are required to ensure any such safeguarded funds are treated as ring-fenced. In the case of Germany, it is not clear that German administrative law even allows the preferred status of e-money liabilities, irrespective of how the segregated account is structured.

Added to that regulatory and legal uncertainty, there is also country risk (e.g. see recent attempt in Cyprus to tax all Cypriot accounts with a 10% savings surcharge) that exists for EMI's given the current financial difficulties faced by many Member States within Europe.

EMI's in the UK, Gibraltar and elsewhere therefore need to (and are required to) consider whether they are able to hold client funds of any substantial size for any prolonged period of time in other European countries.

Pooled liability equals Pooled Risk

A strict construal of the wording in the 2nd E-money Directive, the PSD and the UK and Gibraltar legislation would suggest that if funds are not properly safeguarded the protection intended to be afforded e-money client funds falls away because the funds do not constitute relevant funds that defeat third party creditors of an EMI. This could lead to a situation whereby an EMI has safeguarded customer monies for some but not all its branded programs or for some but not all of its customers (who may be – an whose money may be held- in various European countries).

Ultimately, given the pooled nature of e-money liabilities and the protection intended to be afforded all e-money holders (at least using the Lehman Case Analogy below), failure by an EMI to properly safeguard funds (either due to administrative error or due to country legal and economic risks) would likely impact all e-money holders with an equal pro-rated haircut to the extent the EMI could not make good the deficit.

The Lehman Case Analogy

There appears to be no relevant English or European case-law in respect of the position under the various e-money regulations relating to the treatment of e-money holders where the liabilities fail to be fully safeguarded. However, a recent case (see Schedule A –"Summary of the Lehman Case") in the English courts highlights how an English court is likely to proceed in such circumstances. In my opinion:

- the Lehman Case is highly persuasive as a comparator case involving the definition of relevant funds which are pooled for the benefit of clients of an authorised financial services firm. The case has certain distinguishing features from the position with respect to EMI's but is strong grounds for taking a purposive approach to the protection of e-money clients of a firm (even where the firm fails to properly safeguard funds).
- the Lehman Case is persuasive English law authority for the proposition that an EMI must treat all e-money holder liabilities equally (regardless of whether their funds are in fact properly safeguarded by law or in practice) on a pooled basis in order to avoid the risk of creating an unlawful preference of one e-money holder as against another. That is to say the Lehman case suggests any shortfall in safeguarded funds must be shared equally between all e-money holders

(irrespective of the ability to trace any particular client's monies to safeguarded accounts or otherwise).

As a passing comment, I note that if the Lehman case is good authority for the proposition that all e-money liabilities must be pooled and met from the actual safeguarded funds, in my opinion it would be going to far to hold that, to the extent there is any shortfall between the actually safeguarded funds and the intended safeguarded funds, monies owed to other creditors of the EMI could be used to meet any shortfall in the safeguarded funds.

Given the inherently fiduciary nature of the relationship an EMI must make good any deficit to e-money holders from its own capital, to the extent that this fails then it would, in my opinion, be unlawful to use creditor funds to meet such a deficit as this would give all e-money holders an unlawful preference that extends beyond the statutorily mandated preference for the funds that are actually safeguarded. It is unlikely that a court would allow the English law of trust and fiduciary obligations to be used to go further than the European Directives in this respect to the detriment of unsecured creditors.

25 March 2013

Peter Howitt,

Solicitor, Ramparts Law

Ramparts Law is an independent European law firm based in Gibraltar and specialising in cross-border corporate, commercial and regulatory matters relating to e-commerce, financial services and tax. Please contact info@ramparts.eu if you would like advice on your European e-money and payments strategy and activities.

Schedule A

Summary of the Lehman Case

On 29 February 2012, the Supreme Court handed down its judgment in the matter of *Lehman Brothers International (Europe) (In Administration) [2012] UKSC6*. The Supreme Court upheld the decision of the Court of Appeal in respect of the interpretation of several key issues relating to the protection of client money under the Client Asset Sourcebook of the FSA Handbook (known as CASS 7). The appeal to the Supreme Court was concerned with the meaning and application of CASS 7 for the safeguarding and distribution of client money in the implementation of the Markets in Financial Instruments Directive 2004/39/EC ("MiFID").

CASS 7 provided a code for the safeguarding of client money by regulated firms subject to MiFID. It provided for client money to be identified and promptly paid into accounts that were segregated from a firm's own accounts. Such client money was to be held on trust for the clients for whom it was received and held. In the event of the failure of the regulated firm, the rules provided for the pooling of client money and for its distribution to those entitled to it under that trust, on an equal basis, in the event of a shortfall.

A failure to identify and segregate client money immediately before its administration by Lehman Brothers International (Europe) Limited gave rise to some crucial questions in the interpretation and application of CASS 7. The final judgment decided that the following clients would be treated equally under the pooling and distribution provisions:

1. Clients whose money was held in segregated accounts;
2. Clients whose money was identifiable in Lehman's own accounts but would have been segregated by the firm but for the intervention of administration and freezing thereafter;
3. Clients whose money was identifiable as client monies in Lehman's own accounts and should have been recognized and segregated but was never so recognized or segregated.

   (referred to herein as the "**Lehman Test**")

The court found that all client funds meeting the Lehman Test must be treated equally given the fiduciary nature of the relationship between firm and client and must be treated preferentially as against Lehman's own funds and any other non-preferred creditors. In essence they decided that the statutory trust over client funds arose on receipt of funds from a client rather than at the moment of segregation (the "**Claims Basis**"). The trust also applied to identifiable client funds (that had not been correctly segregated and identified as client money) held in the firm's own accounts even if that caused a loss to other preferred clients (who must share the total pool of protected funds with a wider class of protected clients). The Court found that there was nothing unrealistic in a scheme which resulted in all client's sharing the misfortune of a firm's failure equally, that is to say, as between themselves protected clients should have no priority over each other with respect to the pool of funds available to meet their liabilities regardless of whether the funds were in fact properly segregated or not.