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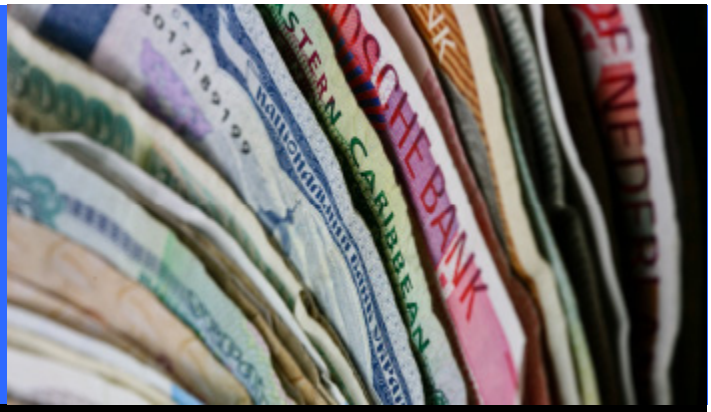

Financial Regulatory Update October 9, 2024

Financial Conduct Authority Proposals for Strengthening the Safeguarding Regime for Electronic Money and Payments Firms

This briefing note assesses the FCA's proposed changes and the potential impact for payments and e-money firms.

On 26 September 2024, the Financial Conduct Authority (**FCA**) published its long-awaited consultation paper on proposed changes to the safeguarding regime for payments and e-money firms in the United Kingdom (**CP24/20**).

Payment and e-money firms are required to protect funds received in connection with making a payment or issuing e-money ("**relevant funds**"). The requirements are designed to protect consumers in the event of a firm failure and ensure that consumers receive the maximum value of their funds as quickly as possible.

The current safeguarding requirements are set out in the Payment Services Regulations 2017 (**PSRs**) and the Electronic Money Regulations 2011 (**EMRs**) as supplemented by Chapter 10 of the FCA's Approach Document[1].

Why is the FCA consulting?

The FCA is consulting at this time as a result of the confluence of the following three concerns: increasing significance of the payments and e-money sector in the UK market; identified failings in safeguarding practices at a wide range of relevant firms; and legal uncertainty in the legal framework applied when a relevant firm enters an insolvency process.

The current safeguarding requirements were designed to support competition, innovation and consumer protection in a developing sector. Given the continued growth of the sector in the UK market and the consequential increasing reliance upon e-money accounts by consumers (often vulnerable consumers)[2], the risk of widespread consumer harm in the event of a large firm failure is intensifying.

The FCA has found evidence of significant failings in firms' practices in relation to safeguarding. The FCA states in CP24/20 that of those firms that became insolvent between 2018 and 2023, there was an average shortfall of 65% in funds owed to clients (this is the difference between funds owed and funds safeguarded). Deficiencies in safeguarding rules were also noted in the Payment Services Regulations Review and Call for Evidence conducted by His Majesty's Treasury (**HMT**). This prompted HMT to suggest that responsibility for developing detailed safeguarding requirements could be transferred to the FCA.

Further, two recent court judgments[3] in the UK have left many questions unanswered and significant legal uncertainty in the legal framework which applies when a payment or e-money firm safeguarding funds enters an insolvency process.

What is safeguarding?

Firms which are authorised by the FCA as payment institutions, e-money institutions and credit unions that issue e-money (collectively, "**Firms**") are required under the PSRs and the EMRs to protect funds received in connection with executing a payment transaction or in exchange for e-money issued. Firms are required to do this immediately on receiving the funds. The requirements are designed to protect consumers in the event of the firm's failure by ensuring that consumers receive the maximum value of their funds as quickly as possible.

Firms are able to safeguard relevant funds in two ways: (i) the segregation method; or (ii) the insurance or comparable guarantee method. By far the most popular method is currently the segregation method. The segregation method involves a firm segregating the relevant funds (i.e. keeping them separate from all other funds held) and, if the funds are still held at the end of the business day following the day on which they were received, to deposit the funds in a separate account with a credit institution or the Bank of England or to invest the relevant funds in secure, liquid assets approved by the FCA and place those assets in a separate account with an authorised custodian.

What is the FCA proposing?

The FCA is proposing a two-staged process to strengthen the safeguarding regime, referred to as the "**interim-state**" and the "**end-state**". The reason for the two-stage process is that

Parliamentary time is needed in order to pass new legislation for the end-state proposals to take effect. However, in light of the significant concerns identified by the FCA, the FCA is proposing to take some interim measures to strengthen safeguarding practices and increase regulatory oversight and monitoring in the shorter term.

Proposed interim-state rules

The proposed interim-state rules are designed to mitigate in the shorter term the FCA concerns which have been highlighted in CP24/20. Many of the requirements in the interim-state rules are closely related to similar concepts that appear elsewhere within the FCA armoury of rules and guidance. The new rules will be added to the Client Assets and Supervision Sourcebooks of the FCA Handbook. The measures include:

- **Improved books and records:** Firms will be required to:
    - Have adequate policies and procedures to ensure compliance with the safeguarding regime.
    - Maintain accurate records and accounts to enable them, at any time and without delay, to distinguish between relevant funds and other funds.
    - Perform internal reconciliations at least once each business day to ensure they are safeguarding the correct account of relevant funds and ascertain the reason for any discrepancies and resolve any excess or shortfall.
    - Perform external reconciliations and ascertain the reason for any discrepancies and resolve any excess or shortfall.
    - Notify the FCA (in writing and without delay) if: (i) their internal records are materially out of date, inaccurate or invalid; (ii) they will be unable to perform a reconciliation; (iii) they cannot resolve a discrepancy arising out of a reconciliation; or (iv) if, at any time during the previous year, there was a material difference between the amount which the Firm should have been but actually was safeguarding.
- **Resolution pack:** Firms will be required to maintain a resolution pack to improve the ability to retrieve information helpful to the timely return of relevant funds in the event of the Firm's insolvency.
- **Enhanced monitoring and reporting:** Firms will be required to:
    - Have their compliance with safeguarding requirements audited annually, with the audit report submitted to the FCA.
    - Submit a new monthly regulatory return to the FCA in relation to safeguarding practices. The return will require Firms to provide data on (amongst other things) the amount safeguarded.
    - Allocate responsibility for oversight of compliance with safeguarding requirements to a specific individual within the Firm.
- **Strengthening safeguarding practices:**

- Additional safeguards will be imposed where Firms invest relevant funds in secure liquid assets.
- Firms will be required to consider diversification of third parties with which they hold, deposit, insure or guarantee relevant funds that it is required to safeguard and due diligence requirements.
- Additional safeguards and more detailed requirements on how Firms can use insurance or guarantees to safeguard relevant funds.

Proposed end-state rules

In addition to the interim-state rules, the end-state rules will impose two key requirements: (1) a statutory trust over relevant funds and assets, insurance policies and guarantees used for safeguarding; and (2) a requirement that Firms receive relevant funds directly into a designated safeguarding account. The architecture for the new statutory trust regime is strongly grounded in the statutory trust currently used in the FCA's client assets regime applicable to investment firms.

The table below sets out a summary of the key proposals in both the interim-state and end-state[4]:

Main proposals	**Interim-state proposals**	**End-state proposals (in addition to interim-state proposals)**
Improved books and records	Enhanced record keeping and reconciliation requirements Requirement to maintain resolution pack	Updated record keeping and reconciliation requirements
Enhanced monitoring and reporting	Requirement for Firms to have safeguarding practices audited by an external auditor, with the safeguarding audit submitted to the FCA Requirement for firms to complete a monthly safeguarding regulatory return	
Strengthening elements of safeguarding practices	Requirements to exercise due skill, care and diligence in selecting and appointing third parties Requirements to consider the need for diversification	Relevant funds must be received into a designated safeguarding account at an approved bank, with limited exceptions Agents and distributors cannot receive relevant funds unless the principal firm

	Additional requirements on how Firms can safeguard relevant funds by insurance or comparable guarantee	safeguards the estimated value of funds held by agents and distributors in a designated safeguarding account Additional requirements when firms only safeguard relevant funds by insurance or comparable guarantee
Holding funds, etc. under a statutory trust		Firms will receive and hold the following under a statutory trust: • Relevant funds; and • Assets, insurance policies and guarantees used for safeguarding

Impact for relevant payment and e-money firms

The proposed changes, especially the interim-state requirements, do not represent a radical shift in the safeguarding requirements applicable to relevant Firms. Many of the requirements already apply and the changes are being introduced in order to support a greater level of compliance with the existing requirements, support more consistency in compliance and enhance regulatory oversight to assist with earlier identification or where risk may be building up. The end-state rules will, if implemented as proposed, result in a “CASS” style regime where relevant funds and assets are held on trust for consumers.

The impact of the interim-state rules on Firms should not be underestimated. It is clear that regulatory expectations relating to safeguarding are increasing. Firms are expected to ensure that their policies and procedures and systems and controls relating to safeguarding are robust. In particular, Firms should not underestimate the reconciliation requirements. While these are not new there are currently a wide range of practices and approaches to reconciliation across the sector. All firms will need to ensure that they review their practices and make enhancements in advance of the interim-state rules coming into force.

In advance of the interim-state rules coming into force, Firms will need to conduct a detailed gap analysis of their current practices relating to safeguarding and will need to uplift their policies and procedures and their systems and controls to ensure compliance with the new rules and regulatory expectations.

When will we know more?

The consultation period closes on 17 December 2024. Thereafter, the FCA will consider the responses received and will publish its response in the form of a policy statement and (presumably) made rules. Most of the interim-state rules will come into force following a six-month transitional period from the publication of final form rules. The FCA is currently targeting the first half of 2025 for this publication. The end-state rules will come into force following a 12-month transitional period from the date of their publication. However, the publication date is (presumably) dependent upon Parliamentary time and therefore the date is currently uncertain.

What should payments and e-money firms do now?

Impacted Firms should assess the extent of the impact of the proposals both in the interim-state and the end-state and consider whether they wish to prepare a response to the consultation.

[1] Payment Services and Electronic Money – Our Approach (November 2021)

[2] The proportion of UK consumers in the UK using an e-money account has grown from 1% in 2017 to 7% in 2022. Approximately 1 in 10 e-money holders use e-money accounts as their primary transactional accounts – Financial Lives Survey

[3] Ipagoo [2022] EWCA Civ 302 and Allied Wallet [2022] EWHC 1877 (Ch)

[4] See Table 1 CP24/20, Section 3.18 page 15

The following Gibson Dunn lawyers prepared this update: Michelle Kirschner and Martin Coombes.

Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding these developments. If you wish to discuss any of the matters set out above, please contact any member of Gibson Dunn's Financial Regulatory team, including the authors in London:

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