

Financial Institutions Advisory and Financial Regulatory Group | September 24, 2009

## New Regime for the Regulation of Payment Services in Europe

The EU Payment Services Directive, which establishes a new regulatory regime for payment service providers, is due to take effect in most EEA member states by 1 November 2009. Many firms that are currently unregulated will require authorisation or registration for the first time. In addition, many regulated institutions offering payment services will need to consider whether they must become separately authorised or registered by national regulators in order to begin or continue offering such services.

### Background

From 1 November 2009, the implementation of the EU Payment Services Directive (the "**PSD**")<sup>1</sup> across Europe will introduce the regulation of all "payment service providers" ("**PSPs**"). PSPs are credit institutions, e-money institutions and any other "payment institutions" that carry on regulated "payment services", which include such activities as money remittance, performing credit transfers and direct debits, operating payment accounts and issuing payment cards.

The term "payment institution" is a new concept introduced by the PSD and covers a broad range of firms, from non-bank regulated financial institutions (such as lenders and prime brokers) to previously unregulated businesses such as money remitters, mobile network operators and non-bank credit card issuers.

Credit institutions and e-money institutions are able to carry out regulated payment services under their existing authorisations, but payment institutions are not. Payment institutions are to be brought within a new authorisation regime and must therefore (subject to transitional provisions) either obtain authorisation as authorised payment institutions ("**APIs**") or become registered as small payment institutions ("**Small**

**PIs**").<sup>2</sup> In addition, from 1 November 2009, APIs, Small PIs and other PSPs will need to comply with the conduct of business rules included in the PSD. These requirements are discussed further below.

The PSD is being implemented in the UK through the Payment Services Regulations 2009 (the "**PSRs**"),<sup>3</sup> which are to be applied and enforced by the FSA. This briefing seeks to explain the PSD in light of the implementation approach taken in the UK.

### Regulated Payment Services

Regulated payment services include the following activities when carried out as a regular occupation or business activity:<sup>4</sup>

- **Execution of credit transfers and direct debits.** This is likely to be broadly interpreted, essentially as encompassing the provision of any service by a

<sup>1</sup> Directive 2007/64 EC.

<sup>2</sup> Generally, a Small PI is a payment institution whose monthly average of transactions (calculated over 12 months) does not exceed €3 million (PSRs, reg. 13(3)).

<sup>3</sup> SI 2009/209.

<sup>4</sup> PSRs, Schedule 1, Part 1. It appears that "regular occupation or business activity" means that the payment services are carried out on more than just an ancillary basis. By way of example, the FSA has indicated that firms such as solicitors and broker-dealers are unlikely to be providing payment services merely through operating their client accounts in connection with their main professional activities: PERG 15.2 Q. 9.

PSP that enables a client to make available an amount of money to a payee.<sup>5</sup>

- **Issuing payment instruments.** This will occur when a PSP issues to a client a physical personalised device or procedure – such as a card, mobile phone, card reader, PIN, login or password – with which the client may request the execution of a payment transaction.<sup>6</sup>
- **Enabling cash transfers on operational payment accounts.** This involves enabling cash to be placed on, or withdrawn from, a payment account if the PSP also carries out all of the operations for operating a payment account.<sup>7</sup> Accepting cash either electronically or over-the-counter, which is then placed on a payment account, falls within scope.<sup>8</sup> Examples of payment accounts include current, e-money, flexible savings, credit card and other flexible cash deposit accounts (or the flexible element of hybrid accounts such as current account mortgages).<sup>9</sup>
- **Money remittance:** This is the transmission of money without the creation of a payment account, but where funds are received by the PSP. This service is likely to be relevant to money transfer companies and hawala brokers.<sup>10</sup>

There are certain exemptions from the new authorisation regime contained in the PSRs which may benefit charities, bureaux de change, retailers offering "cashback", IT and data-processing firms and non-bank ATM operators.<sup>11</sup> Certain intra-group, inter-PSP and clearing and settlement transactions are also excluded from scope, as are specified types of payment instruments such as staff catering cards, store cards and

transport cards, and payments by cash or paper cheque (or certain similar documents). There is also an exclusion for payment services related to securities asset servicing, though this carve-out is narrowly drawn.

## Authorisation

Under the PSRs and associated FSA rules, UK PSPs and their agents will from 1 November 2009 (unless exempt)<sup>12</sup> need to be authorised or registered as follows:

- Credit institutions (banks) can automatically provide or continue to provide payment services in the UK.<sup>13</sup>
- Small PIs, agents of APIs and UK branches of EEA-authorized payment institutions will be subject to registration requirements.<sup>14</sup> Small PIs lawfully providing payment services in the UK before 25 December 2007 need not be registered until 25 December 2010.<sup>15</sup>
- Non-bank financial institutions<sup>16</sup> that (i) are incorporated and established in the UK and (ii) were lawfully carrying out payment services immediately before 25 December 2007 may continue providing payment services in the UK until 1 May 2011.<sup>17</sup> Non-bank financial institutions that are also within a parent undertaking's consolidated supervision,<sup>18</sup> will be deemed to be authorised as APIs until

<sup>5</sup> For "credit transfer", see the analogous definition for "cross-border credit transfer" in EU Directive 97/5/EC on Cross-Border Credit Transfers. For "direct debit", see the PSRs, reg. 2(1).

<sup>6</sup> Paper slips are not considered payment instruments for these purposes. See EU Commission letter of 28.03.08, cited in guidance issued by the European banking industry PSD Expert Group.

<sup>7</sup> PSRs, Schedule 1 Part 1, para. 1(a) and (b).

<sup>8</sup> PERG 15.3 Q. 15.

<sup>9</sup> PERG 15.3 Q. 16.

<sup>10</sup> PERG 15.3 Q. 22.

<sup>11</sup> PSRs, Schedule 1, Part 2.

<sup>12</sup> The PSD allows member states to disapply some or all of the PSD for certain entities. In the UK, credit unions, municipal banks and the National Savings Bank are exempt from the PSRs (save for a notification requirement).

<sup>13</sup> PSRs, reg. 110(1)(d). This includes credit institutions established in other EEA countries exercising "passporting" rights in the UK, as well as UK branches of non-EEA credit institutions (see also PERG 15.2 Q. 7).

<sup>14</sup> PSRs, reg. 4.

<sup>15</sup> PSRs, reg. 123.

<sup>16</sup> Within the meaning of the EU Banking Consolidation Directive (Directive 2006/48/EC) (the "BCD"); e.g., lenders and portfolio managers and advisers.

<sup>17</sup> PSRs, reg. 122(1). To obtain authorisation for continued operation beyond 1 May 2011, applications should be submitted by 1 February 2011.

<sup>18</sup> Pursuant to the BCD, art. 24(1)(e).

24 December 2009. Businesses acting under a deemed authorisation may be included in the register as an API upon due notification to the FSA.<sup>19</sup>

- Other non-bank financial institutions and all other firms whose business comes within the scope of the PSRs will need to apply for authorisation as an API.<sup>20</sup>

The application process for authorisation as an API (or registration as a Small PI) commenced on 1 May 2009.

Note that the transitional provisions described above only relate to authorisation and registration. From 1 November 2009, all PSPs must, unless wholly exempt from the PSRs, comply with the conduct of business rules contained in the PSRs (discussed further below), regardless of authorisation status.

## Passporting

A key benefit of becoming authorised under the PSD is that APIs can, subject to some notification requirements, "passport" their activities and services into other EEA states in a way that is analogous to arrangements provided for in certain other EU financial services legislation.<sup>21</sup>

Note that, in the UK, the PSRs also effectively extend the passporting regime to Gibraltar (which is not a member of the EEA).<sup>22</sup>

Passporting rights are not available to registered Small PIs, nor to firms that are operating under a deemed authorisation pursuant to transitional provisions. In order to benefit from passporting rights, firms that would otherwise qualify for registration as a Small PI or for deemed authorisation to continue performing payment services would instead have to become fully authorised as APIs.

<sup>19</sup> PSRs, reg. 121.

<sup>20</sup> PSRs, reg. 110(1).

<sup>21</sup> PSRs, reg. 23; PSD, art. 25.

<sup>22</sup> PSRs, reg. 127 and Schedule 7.

## Ongoing compliance

APIs (and, where indicated, Small PIs and other PSPs) need to comply with ongoing requirements under the PSRs, including the following:

- **Capital requirements:** An API must at all times maintain "own funds" equal to or greater than the minimum amount of mandatory initial capital,<sup>23</sup> or an amount calculated using one of three specified methods (subject to any adjustment by the FSA), whichever is the greater.<sup>24</sup> This does not apply to registered Small PIs.

The PSRs contain an extensive list of what constitutes "own funds", certain types of which may only qualify if available to the API for unrestricted and immediate use to cover risks or losses.<sup>25</sup>

- **Safeguarding assets:** Sums received from, or for the benefit of, a client for the execution of a payment transaction, and sums received from an API for the execution of a payment transaction on behalf of a client must be either: (i) segregated, with any funds still held at the end of the following business day being either placed in a designated separate account held with an authorised credit institution or invested in assets approved by the FSA; or (ii) covered by an appropriate insurance policy or guarantee.<sup>26</sup>

In the event of insolvency, claims of clients must be paid from the asset pool in priority to all other creditors. Until all such claims have been paid no right of set-off or security may be exercised in respect of the asset pool except to the extent that the right to set-off relates to fees and expenses in relation to operating an account held for the

<sup>23</sup> This amount will be €20,000, €50,000 or €125,000, depending upon the payment services conducted: PSRs, Schedule 3, Part 1.

<sup>24</sup> PSRs, reg. 18(1)(a). However, these capital requirements do not apply to an API that is included in the consolidated supervision of a parent credit institution pursuant to the BCD and if certain additional conditions set out in the BCD, art 69(1) are met.

<sup>25</sup> PSRs, Schedule 3, Part 2.

<sup>26</sup> PSRs, reg. 19. The safeguarding requirements do not apply to payment transactions of £50 or less: PSRs, reg.19(3).

purpose of segregation of funds or holding insurance proceeds.

Registered Small PIs are not subject to any of these requirements.

- **Reporting:** APIs, Small PIs and all other PSPs must comply with the FSA's reporting requirements.<sup>27</sup> These requirements are still being finalised but it is likely that for APIs and Small PIs an annual report will need to be filed with the FSA containing information on compliance with safeguarding requirements, names and details of relevant agents, and any capital requirements.<sup>28</sup>

APIs which also carry out non-payment service activities must provide the FSA with separate payment services accounting information.<sup>29</sup> APIs must also notify the FSA before entering into outsourcing agreements with third parties.<sup>30</sup>

- **Annual fee:** APIs and Small PIs will likely need to pay minimum and income-based annual fees to the FSA. A fee consultation will take place in 2010.<sup>31</sup>
- **Record-keeping:** An API must maintain relevant records and keep them for at least five years from the date on which the record was created.<sup>32</sup>
- **Conduct of business rules:** As mentioned above, all PSPs must, from 1 November 2009, comply with the conduct of business rules contained in the PSRs (discussed further below).

APIs and Small PIs will also be responsible for actions and omissions of employees, agents, branches and outsource service providers, to the same extent as if they had expressly permitted such actions or omissions.<sup>33</sup>

<sup>27</sup> PSRs, reg. 82.

<sup>28</sup> "The FSA's role under the Payment Services Regulations 2009 – Our approach" (FSA, June 2009) ("Approach Paper"), chapter 13.

<sup>29</sup> PSRs, reg. 20(1).

<sup>30</sup> PSRs, reg. 21(1).

<sup>31</sup> Approach Paper, chapter 15.

<sup>32</sup> PSRs, reg. 22(1).

<sup>33</sup> PSRs, reg. 31(2).

Non-compliance with the new regulations and rules can amount to a criminal offence.<sup>34</sup>

## Conduct of business rules

Parts 5 and 6 of the PSRs contain conduct of business rules that contain information requirements and other consumer-protection measures that apply (from 1 November 2009) to all PSPs. For example, PSPs must provide terms and conditions to clients and post-contract information including the amount and currency of payment, and must not deduct charges unless otherwise agreed with the client.

The PSRs provide for certain carve-outs from these rules for any client that is not a consumer, a micro-enterprise or a charity<sup>35</sup> (referred to here as a "**non-consumer client**"), which are, in summary, as follows:

- a PSP may agree with a non-consumer client to disapply the requirements in Part 5 of the PSRs governing (among other things) the provision of information about contractual terms, time limits for execution, service charges and confirmation of orders and executions;<sup>36</sup>
- a PSP may agree with a non-consumer client to disapply the conduct of business rules in Part 6 of the PSRs which relate to: (i) charges; (ii) client consent to payment services; (iii) the onus on the PSP to prove authorisation; (iv) the £50 limitation on payer's liability for loss caused by any third party; (v) rights to a refund in case of unreasonable overpayment; (vi) the non-revocation of payment orders; and (vii) liability of the PSP for defective or non execution;<sup>37</sup> and
- for non-consumer clients the PSP need only ensure that cash placed on a payment account is

<sup>34</sup> PSRs, reg. 110.

<sup>35</sup> A consumer is an individual who, in contracts for regulated payment services, is acting for purposes other than a trade, business or profession; a micro-enterprise is any entity with fewer than 10 employees, and an annual turnover/balance sheet total not exceeding €2 million (PSRs, reg. 2(1)).

<sup>36</sup> PSRs, reg. 33(4).

<sup>37</sup> PSRs, reg. 51(3).

made available no later than the end of the business day, as opposed to immediately, after receipt of the funds.<sup>38</sup>

The PSRs also contain carve-outs for low-value payment transactions (where contracts forbid payment transactions exceeding €30 (or €60 if UK-only), provide for a spending limit of €150 (or €300 if UK-only), or allow for funds not exceeding €500 to be stored).<sup>39</sup> These carve-outs affect general contract information requirements and the use of payment instruments.

## Territorial Scope

The PSD covers payment services "provided within" the EEA;<sup>40</sup> that is, provided in or from any member state of the EEA (such as the UK), regardless of the location or domicile of the PSP, payee or payer, and regardless whether the purpose or result of the activity is a transfer of funds to or from an account outside the EEA.<sup>41</sup>

However, the detailed conduct of business requirements generally only apply where the PSP is (or, where there is a PSP for each of the payer and the payee, both PSPs are), located in the EEA and the payment services are carried out in euro or another valid currency of an EEA member state.<sup>42</sup>

<sup>38</sup> PSRs, reg. 72.

<sup>39</sup> PSRs, regs. 35 and 53.

<sup>40</sup> PSD, art. 2(1); extended from the EU to the EEA pursuant to the Decision of the EEA Joint Committee, No. 114/2008.

<sup>41</sup> No definition exists of "provided within" in the context of the PSD, but the PSRs, reg. 110 (criminal offences), admit of such a broad interpretation. Note, though, that the FSA "would not generally expect a payment services provider incorporated and located outside the EEA to be within the scope of the regulations, if all it does is to provide internet-based and other services to UK customers from that location": see the Perimeter Guidance Manual of the FSA Handbook ("PERG") 15.6 Q. 46.

<sup>42</sup> See PSRs, reg. 73 (value date and availability of funds), for the exception.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

If you wish to receive more information on the topics covered in this memorandum, you may contact your regular Shearman & Sterling contact person or any of the following:

<b>Barnabas W.B. Reynolds</b> London +44.20.7655.5528 barney.reynolds@shearman.com	<b>Katja Kaulamo</b> Frankfurt +49.69.9711.1719 katja.kaulamo@shearman.com	<b>Pierre-Nicolas Ferrand</b> Paris +33.1.53.89.7177 pierre-nicolas.ferrand@shearman.com	<b>Tobia Croff</b> Rome +39.06.697.679.209 tobia.croff@shearman.com	<b>Azad Ali</b> London +44.20.7655.5659 azad.ali@shearman.com
<b>Thomas Donegan</b> London +44.20.7655.5566 thomas.donegan@shearman.com	<b>John Adams</b> London +44.20.7655.5740 john.adams@shearman.com	<b>James Brilliant</b> London +44.20.7655.5612 james.brilliant@shearman.com	<b>Aatif Ahmad</b> London +44.20.7655.55120 aatif.ahmad@shearman.com	

BROADGATE WEST | 9 APPOLD STREET | LONDON | EC2A 2AP | WWW.SHEARMAN.COM

©2009 Shearman & Sterling LLP. As used herein, "Shearman & Sterling" refers to Shearman & Sterling LLP, a limited liability partnership organized under the laws of the State of Delaware.