Statement of

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before the

Banking and Finance Committee

California State Assembly

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Chairman Dickenson, members of the Committee, thank you for inviting me to appear before you today to discuss the technology of consumer financial transactions. With this written submission, I intend to (1) describe some recent regulatory developments that affect mobile payment providers, and (2) provide an overview of how mobile payment providers, particularly providers facilitating acceptance of mobile payments, fit into the existing regulatory and contractual framework.

INTRODUCTION

As we discussed the last time I appeared before this committee, California has a long served as an incubator to major innovations in consumer financial services. The credit card, the multi-party payment system, peer-to-peer lending, and, most recently, virtual currency were all conceived of or developed in California. No single factor explains why California has been the home to so many truly revolutionary innovations in the financial services space. The size of the state, its abundant natural resources, and its research universities all deserve at least some credit.

California lawmakers and regulators have been instrumental to this legacy of innovation. They have frequently avoided the temptation to use law and regulation to protect entrenched firms against disruptive competition. This is a risk, however, against which lawmakers and regulators must be ever vigilant. Laws and regulations, even those offered in the name of consumer protection, can work against the consumer interests that they exist to serve by inhibiting competition.

In my view, this is a particular risk in the area of mobile payments given the long list of laws and regulations that already govern how financial institutions provide financial services to consumers. Most of the activities undertaken by mobile payment providers is already governed by existing laws. As a result, new laws and regulations will unlikely provide meaningful benefits to consumers, but they may significantly increase barriers to competition.

RECENT DEVELOPMENTS IN THE REGULATORY FRAMEWORK

My prior testimony provided an overview of the regulatory framework that governs mobile payments. I will not recount that discussion here (but instead attach a corrected version of that testimony). Instead, let me highlight a handful of reasonably significant developments at the Federal level, here in California and elsewhere: the virtual currency guidance promulgated by the U.S. Department of the Treasury, AB 786, and the regulations issued by the Georgia Department of Banking and Finance regarding the Merchant Acquiring Limited Participant Bank.

- The Financial Crimes Enforcement Network's Virtual Currency Guidance

Bitcoin has exploded into public consciousness over the past year, but it is not the only or even the first widely traded virtual currency.[1] And although Bitcoin and other virtual currencies are sometimes portrayed as completely unregulated, the Federal government made clear in March of this year that Bitcoin and other virtual currencies fall within the scope of existing Federal law.

[1] Other major virtual currencies include Ripple, Litecoin, Namecoin, and PPCoin, and dozens of smaller virtual currencies exist as well.

The Financial Crimes Enforcement Network ("FinCEN") issued a guidance explaining the responsibilities owed by those who create, obtain, distribute, exchange, accept or transmit virtual currencies under the Bank Secrecy Act.[2] The guidance defines "virtual currency" as "a medium of exchange that operates like a currency in some environments, but does not have all the attributes of real currency," and lacks especially status as legal tender in some jurisdiction.[3] Under this broad definition, the guidance identifies a subcategory of special concern—"convertible" virtual currencies. It defines a "convertible virtual currency" as a currency that "either ha[s] an equivalent value in real currency, or acts as a substitute for real currency."

The guidance then imposes responsibilities on certain parties that handle "convertible virtual currencies." The guidance explains that "exchangers" of virtual currencies and "administrators" of virtual currency systems are money transmitters within the meaning of the Bank Secrecy Act. As such, the guidance requires "exchangers" and "administrators" to implement anti-money laundering programs and to report suspicious transactions to FinCEN unless they qualify for an exemption to the regulatory definition of a money transmitter.[4] The guidance, however, absolves "users" of any such responsibilities, clarifying that both consumers and merchants can purchase virtual currencies and engage in virtual currency transactions without running afoul of the BSA.

[2] FinCEN Guidance FIN-2013-G001.
[3] *Id.*
[4] An "exchanger" is one "engaged as a business in the exchange of virtual currency for real currency, funds, or other virtual currency." An "administrator" is one "engaged as a business in issuing (putting into circulation) a virtual currency, and who has the authority to redeem (or withdraw from circulation) such virtual currency.'" The guidance does not address the relationship, if any, between this term "exchanger" and other regulations that define "currency exchangers." As FinCEN stated in FIN-2008-R004, addressing whether a foreign exchange consultant was a currency dealer or money transmitter, "[t]he term 'currency dealer or exchanger' is defined in our regulations to include every person who deals in or exchanges currency as a business 'other than a person who does not exchange currency in an amount greater than $1,000 in currency or monetary or other instruments for any person on any day in one or more transactions.'"

Even limited to "convertible" virtual currencies and certain parties in the virtual currency value chain, the guidance applies quite broadly. It sweeps in virtual currencies that have a centralized repository, such as Activision Blizzard, the Santa Monica-based repository for World of Warcraft currency, as well as distributed systems such as Bitcoin and Ripple, which utilize virtual currency payment processors.[5] It also clarifies that an "exchanger" or "administrator" triggers Federal regulatory oversight even if a system relies on a single exchange to enable participants to convert real currency into virtual currency or direct distributions of virtual currency to other users.[6]

- California's Amendment to the Money Transmission Act, AB-786

This Committee contributed a significant regulatory development with the passage of AB-786. AB-786 reduces regulatory burdens for some companies that were struggling to reconcile their operations with California's Money Transmission Act. With that said, it does not address every objection leveled at the current law.

AB-786 reduces regulatory burdens in two ways. First, it creates an exemption from the definition of money transmission for businesses that deliver payroll money on behalf of an employer to an employee, including delivery of payroll taxes to federal and state agencies,

[5] The Bitcoin core developers describe Bitcoin as an open source, peer-to-peer technology that operates through a distributed consensus system. *See* How Does Bitcoin Work?, http://bitcoin.org/en/how-it-works (accessed November 15, 2013). Ripple Labs programmers describe Ripple as an open source system made up of "a network of financial accounts" operated through "an automated system" or distributed exchange. *See* Getting Started With Ripple, https://ripple.com/guide/ (accessed November 15, 2013).

[6] The act of converting real currency into virtual currency and vice versa does constitute money transmission. "[A]n exchanger (acting as a "seller" of the convertible virtual currency) that accepts real currency or its equivalent from a user (the "purchaser") and transmits the value of that real currency to fund the user's convertible virtual currency account with the administrator. . . constitutes transmission to another location, namely from the user's account at one location (e.g., a user's real currency account at a bank) to the user's convertible virtual currency account with the administrator."

payments into employee benefit plans, and distributions of other authorized deductions.[7] The amendment also includes a number of technical changes to the existing regulatory regime. These include a reduction of the amount of tangible shareholder equity a licensee must maintain,[8] a change in the definition of marketable security that allows companies to hold funds on a custodial basis for their customers in FDIC insured accounts, and the elimination of the requirement for a receipt when a money transmitter is used to transmit funds in connection with the purchase of goods or services.[9]

Although this Committee should take pride in these accomplishments, AB-786 left some work undone. The law does not clarify the definition of "money transmission" under the Act. Firms that merely act as agents of payment for other firms are still subject to regulation as money transmitters even though such businesses do not raise the types of consumer protection issues raised by traditional money transmitters. Nor does the statute tackle the problem of operating a national business under a state licensing regime in which the various states choose not to recognize the validity of one another's licensing and supervisory regimes.

- Georgia's Merchant Acquiring Limited Purpose Bank

At least one state has taken a new tack in regulating payment processor services that, if widely adopted, could ease the burden of nationwide licensing applications that most electronic payment providers currently face. In 2012, Georgia passed the Merchant Acquirer Limited Purpose Bank Act.[10] The Act created a new state charter for corporations that perform merchant

[7] Assemb. Bill No. 786 (2013-2014 Reg. Sess.) § 2.
[8] *Id.* at § 4.
[9] *Id.* at § 8.
[10] O.C.G.A. § 7-9-1 *et seq*.

acquiring activities or settlement activities.[11] Earlier this year, the Georgia Department of Banking Finance issued regulations defining the scope of operation for such institutions.

The Act and associated regulations create a charter for banks associated with transaction processors. They allow processors to create a limited purpose "bank" to hold funds associated with merchant processing and acquiring activities. This gives the processors direct access to FDIC insurance and, at least potentially, membership in private and quasi-public payment networks. The law severely limits the ability of such banks to accept deposits or permit withdrawals. Basically, the bank is limited to holding funds for the associated processor even if the bank chooses to obtain FDIC insurance. The Georgia law also requires the chartered institution to maintain at least 50 employees in the state devoted to merchant acquiring services (or that it partner with a larger, eligible in-state organization to do the same) and that it maintain at least $3 million in capital at all times.[12] Entities that obtain charters under Georgia's Act will be subject to oversight by the Georgia Department of Banking and Finance and, at potentially, the FDIC.

The Act appears to offer one possible solution to the myriad state and federal laws and regulations currently in existence. Many states, including California, specifically exempt state

[11] The Act defines "merchant acquiring activities" as "various activities associated with effecting transactions within payment card networks, including obtaining and maintaining membership in one or more payment card networks; signing up and underwriting merchants to accept payment card network branded payment cards; providing the means to authorize valid card transactions at client merchant locations; facilitating the clearing and settlement of the transactions through a payment card network; providing access to one or more payment card networks to merchant acquirer limited purpose bank affiliates, customers, or customers of its affiliates; sponsoring the participation of merchant acquirer limited purpose bank affiliates, customers, or customers of its affiliates in one or more payment card networks; and conducting such other activities as may be necessary, convenient, or incidental to effecting transactions within payment card networks" and "settlement activities" as "the processing of payment card transactions to send to a payment card network for processing, to make payments to a merchant, and, ultimately, for cardholder billing." *Id.* at § 7-9-3.

[12] O.C.G.A. § 7-9-11.

chartered, federally insured institutions from the scope of their money transmission regimes.[13] (And to the extent that they do not, the effort to apply a licensing regime to an out-of-state bank from which they exempt domestic banks would be vulnerable to statutory and Constitutional preemption arguments.) If other states were to follow Georgia's lead, it would be possible for electronic payments providers to obtain a charter in their home states and perform acquiring and settlement services without necessarily having to obtain separate licenses for every state in which they operate. Instead, they would be subject to the same federal regulation and oversight *and* state-level regulation without having to conduct such an onerous, time-consuming, and expensive licensing process.

MOBILE PAYMENTS

With that survey of what is new on the regulatory front, it is worth backing up and asking what it is truly new about mobile payments. In my view, the answer is relatively little. By and large, new payment processing services ride on the rails of existing services. Some of those institutions are private such as Visa and MasterCard. Others are public or quasi-public as is the case with the check clearing services administered by the Federal Reserve. All of these systems have well established rules that define the responsibilities of system participants to consumers and merchants.

Historically, a merchant could only accept MasterCard or Visa payment cards by entering into a contract with a bank, known in the industry as an acquirer, licensed to sign merchants to accept the transactions issued by those systems. Over the past decade, MasterCard and Visa have accepted that banks have little interest in establishing direct contractual relationships with

[13] *See, e.g.*, Cal. Fin. Code § 2010(d).

businesses that generate less than $100,000 in transaction volume. To accommodate such merchants, the card networks have adopted rules that allow other entities to contract directly with those merchants. Those entities are known as "Payment Facilitators" ("PFs") and "Payment Service Providers" ("PSPs") under the Visa and MasterCard operating rules. The card networks impose a long list of requirements on such entities and require them to have a direct contractual relationship with an acquirer.

The requirements borne by PSPs and PFs fall into two broad categories—financial responsibility and operational compliance. Network rules limit PSPs and PFs to facilitating payments with small merchant. The rules require that any merchant that generates more than $100,000 in annual transaction volume for either Visa or MasterCard must separately contract as a Merchant with a licensed acquirer.[14] All PSPs and PFs must accept financial responsibility for all transactions they help process, and PSPs and PFs are obligated to terminate a sub-merchant agreement when so ordered by an acquirer or by Visa or MasterCard for acts deemed to be fraudulent or otherwise in violation of the applicable rules.[15] Finally, PFs are obligated to ensure "ongoing compliance" with the MasterCard Rules for all sub-merchants[16] and PSPs under the Visa Rules must comply with and ensure that all sub-merchants comply with Payment Card Industry Data Security Standard (PCI DSS) and Payment Application Data Security Standard (PA-DSS).[17]

Although PSPs and PFs are directly answerable for any problems that arise with their merchants, the card networks assign significant supervisory responsibilities to the acquirers that

[14] MasterCard Rules § 5.4; Visa Rules at 408.
[15] MasterCard Rules § 5.1.2.1; Visa Rules at 407, 537.
[16] MasterCard Rules § 5.1.2.1.
[17] Visa Rules at 407.

work with PSPs and PFs as well. The Visa and MasterCard Rules obligate acquirers to take responsibility for the actions of their PSPs and PFs.[18] Acquirers must ensure that their PSPs and PFs satisfy all obligations under the applicable Rules, including enforcing PSPs' and PFs' duty to execute comprehensive written agreements with sub-merchants that do not abrogate any rights or liabilities of the acquirer and PSP or PF.[19] Acquirers that fail to live up to these responsibilities are ultimately answerable to other participants in the system. Under MasterCard's rules, for example, when a contract between a PF and a merchant is deficient in some respect, the acquirer bears responsibility to issuers and acquirers for any chargeback and compliance issues raised by the PF's customer. The MasterCard Rules expressly state that if a PF's contract with a sub-merchant is deficient in some respect, the acquirer remains liable for all chargebacks and compliance issues.[20]

This waterfall of obligations is merely illustrative. Access to the check clearing systems is similarly restricted. Financial institutions that originate ACH transactions are obliged to scrutinize the operations of their customers. Those that fail to adhere to those responsibilities face the risk of censure or financial penalties at the hands of their prudential regulators.[21]

Given the sweep of obligations, public and private, that govern the rails on which emerging payment systems run and address consumer privacy concerns that may arise for such

[18] *See, e.g.* MasterCard Rules § 5.4.1.
[19] MasterCard Rules § 5.5.2; Visa Rules at 537.
[20] MasterCard Rules § 5.5.3.1 ("The failure of a Payment Facilitator to include the substance of any one or more of such Standards [contained in MasterCard Rules 5.6 through 5.12] in the Sub-merchant agreement or the grant of a variance by the Corporation with respect to any one or more of such Standards *does not relieve an Acquirer from responsibility for chargebacks or compliance related to the Activity of or use of the Marks by the Sub-merchant*.") (emphasis added).
[21] FDIC Financial Institution Letter FIL-3-2012, "Payment Processor Relationships: Revised Guidance" (January 31, 2012) The letter warns that institutions that fail to adequately manage and oversee their payment processor relationships may be liable for facilitating fraudulent activity on the part of the processor or merchant client, including but not limited to, "facilitating or aiding and abetting consumer unfairness or deception under Section 5 of the Federal Trade Commission Act." *Id.* p. 2.

systems, there is little need to create to new requirements, particularly at the state level. Most providers of electronic payments are already regulated through their connection to existing payment systems, and the creation of new regulatory requirements at the state level will simply create duplicative and redundant oversight.

CONCLUSION

This is an exciting time for the payment industry, especially in California where so many new businesses find their start. Emerging technologies are creating new opportunities for financial institutions, merchants, and consumers to reinvent commerce, especially in the online and mobile spaces. The Legislature should keep in mind California's special role as an incubator for new technologies as it reviews the MTA and other laws and regulations and considers modifications to its current regulatory structure. With an eye to eliminating redundant and unnecessary forms of oversight while maintaining robust protections for consumers, the Legislature can operate to protect consumers from loss while aiding in the development of new consumer financial transaction technologies.

Thank you for inviting me to appear today. I am happy to answer any of the committee's questions.

APPENDIX 1

Statement of

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and

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before the

Banking and Finance Committee

California State Assembly

State Capitol, Room 444

Sacramento, California

March 11, 2013

(Corrected November 2013)

Chairman Dickinson, members of the Committee, thank you for inviting me to appear before you today to discuss the California Money Transmission Act and its effect on innovation in the payments industry.[1] With this written submission, I intend to (1) provide the Committee with some background on the role that California has played in incubating new technologies for value exchange, (2) sketch the regulatory framework that governs the payment industry; (3) discuss some of the issues that have arisen since the California Money Transmission Act was last amended; and (4) offer some thoughts about possible modifications to the California Money Transmission Act that would address some of these issues.

INTRODUCTION

California is widely regarded as the nation's innovation and technology capital. Many of the technologies that shape the modern economy were conceived, developed and perfected in California. The smart phone, integrated circuit, and, of course, the World Wide Web have changed how people work and live. Each was brought to life by people and businesses resident in California.

California has also served as an incubator for innovation in industries not generally associated with technology. In particular, California has been home to companies that have shaped the consumer financial services industry. Since A.P. Giannini founded the Bank of Italy in San Francisco in 1904, California businesses and entrepreneurs have played key roles in the development of consumer credit, credit cards, debit cards and electronic payments.[2] These

[1] I am appearing today in my capacity as an adjunct professor at Berkeley Law School. In my private practice, I have represented and currently represent a number of clients that participate in the payments industry. The opinions expressed in today's testimony are my own and may not represent those of my firm or my clients.

[2] The Money Transmission Act itself recognizes California's status as a hub of innovation. *See* Cal. Fin. Code § 2001(a) ("Money transmission businesses conduct a significant amount of

developments not only provided millions of consumers with access to services that were once reserved for the nation's elite, but they also enabled California companies to take on and, in some instances, replace well-financed incumbents.

Unfortunately, recent legislative changes have cast a shadow on California's legacy of innovation in the financial services industry. One of these legislative changes is California's Money Transmission Act ("MTA")—the subject of today's hearing. The recent effort to amend the MTA, which underwent a substantial renovation in 2010, could have significant impact on businesses that operate in California and with California consumers.

While the Legislature certainly has an interest in protecting California consumers from the risk of loss associated with entrusting funds to an intermediary, the difficulty that the Legislature faces in amending the MTA lies in properly situating the statute within the complicated scheme of overlapping laws and regulations already directed at companies in the financial services sector. The payment industry, in particular, is heavily regulated both by the State and at the federal level. In some cases, California companies that do business in other states are subject to those states' laws on top of the existing California and federal regulations. Thus, the Legislature should keep in mind the web of regulation with which California companies are already burdened as it considers making amendments to the MTA. Some of the existing regulation to which companies in the payments industry are already subject is outlined below.

Existing Regulatory Framework

In 2010, the Legislature significantly increased the regulatory burden facing innovators in the electronic payment industry with the passage of the MTA. Before the MTA was signed,

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business in this state and technological advances are occurring in the provision of money transmission services.").

California only required companies that issued money orders and travellers checks or that helped to move money abroad to obtain a license to operate their businesses. The MTA extended this licensing requirement to *domestic* money transmitters—*i.e.*, any person that engages in money transmission *with*, *to*, or *from* persons located in California—as well as to stored valued providers.

Following the passage of the MTA, California firms seeking to enter the payment business face a stark choice: find a suitable regulated chartered partner (*i.e,*. a bank or other depository institution) or obtain licenses from all 50 states as a money services provider. The first option brings the electronic payments provider under the indirect supervision of the state and federal agencies responsible for regulating the chartered partner (*e.g.*, FDIC or OCC). This option also carries costs associated with revenue-sharing and compliance, although some compliance costs and responsibilities may be shared with the chartered partner. The second option brings the electronic payments provider under the direct supervision of various state entities. It also brings with it the initial burden of acquiring state licenses—potentially a multi-year process with associated fees and costs that can easily exceed a million dollars. Annual maintenance costs for state licensing can also be significant.

Other states that regulate "money transmission" activity typically require a license from the state's department of financial institutions, or equivalent body. The licensing requirements can vary widely, but in general, demand that an applicant demonstrate good character and sound financial standing, competency to operate, reasonable promise of success, intent to comply with laws and regulations, and perhaps most importantly, impose substantial capital requirements. The application itself is a substantial undertaking for any business—but especially for a new company in its early stages of fundraising. An MTL application typically requires detailed

information on the applicant; personal information about the officers, directors, or control persons; financial statements (often required for the applicant and its board); and criminal and litigation records. State regulators may also have broad discretion to seek additional information they deem necessary. Application filing fees can range from a few hundred dollars to several thousand, and yearly fees are typically imposed after the license is granted. Moreover, a requirement of a surety bond or deposit of other eligible securities is typically imposed. The bonding requirements can range from $10,000 to $7 million. Cumulatively, these requirements impose a significant burden on a company engaged in money transmission activity. Multiplied by the number of individual states that might demand the company to obtain a license, the cost and effort required to obtain state-by-state MTLs could be prohibitive for a startup or other new business venture.

Companies engaged in money transmission activity are also subject to regulation by the federal government. The Financial Crimes Enforcement Network ("FinCEN"), an arm of the United States Treasury, has been delegated the authority to administer the Bank Secrecy Act ("BSA").[3] The BSA grants FinCEN the authority to regulate "money services businesses," a term that is defined categorically under FinCEN's regulations. A person who provides "money transmission services" qualifies as an omnibus category of "money services businesses" under the BSA.[4] "Money transmission services" are further defined as "the acceptance of currency, funds, or other value that substitutes for currency from one person *and* the transmission of currency, funds, or other value that substitutes for currency to another location or person by any

[3] Title III of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 ("USA PATRIOT Act"), P.L. 107-56, 115 Stat. 296, amends certain provisions of the BSA. *See* 12 U.S.C. §§ 1829b, 1951-1959e, and 31 U.S.C. §§ 5311-5314e, 5316-5332e. Title III of the USA PATRIOT Act is separately referred to as the International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001.

[4] 31 C.F.R. § 1010.100(ff)(5).

means."[5] Such businesses are required to register with FinCEN and file reports with FinCEN regarding suspicious transactions.[6]

Aside from the overlapping regulatory regimes through which money transmitters must navigate, firms in the payment industry must comply with a long list of laws and regulations. Regulation of consumer financial services is complicated. Payments companies are typically bound by federal law providing consumers with recourse in the event of a disputed charge.[7] Firms that rely on a stored value purse to support their payment applications may be required to implement Customer Identification Programs and to report suspicious transactions to FinCEN.[8] Firms must scrutinize their operations for compliance with the requirements laid down by the Office of Foreign Assets Control ("OFAC").[9] Firms that store customer bank account or other

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[5] *Id.*

[6] 31 C.F.R. § 1022.320(a).

[7] For example, for mobile payment transactions involving credit cards, Regulation Z, which implements the Federal Truth in Lending Act, limits a cardholder's liability to $50 for unauthorized charges. 12 C.F.R. § 226.12(c). Likewise, the federal Electronic Fund Transfer Act provides similar limitations on liability for unauthorized debit card charges. 15 U.S.C. § 1693g(a).

[8] All federally regulated banks are required to have a written CIP pursuant to section 326 of the USA PATRIOT Act. FinCEN has imposed similar requirements on non-bank providers and sellers of what it defines as "prepaid access." 76 FR 45403-02, 45414 (imposing CIP requirements on sellers of prepaid access that "mirror the customer identification programs required of other financial institutions"); 31 C.F.R. § 1026.220(a)(1) (imposing CIP requirements on futures commission merchants and introducing bankers); 31 C.F.R. § 1024.220(a)(1) (same for mutual funds); 31 C.F.R. § 1023.220(a)(1) (same for securities broker-dealers).

[9] *See* Trading With the Enemy Act ("TWEA"), 50 U.S.C. App. § 1–44; International Emergency Economic Powers Act ("IEEPA"), 50 U.S.C. § 1701 *et seq.*; Antiterrorism and Effective Death Penalty Act ("AEDPA"), 8 U.S.C. §1189, 18 U.S.C. § 2339B; United Nations Participation Act ("UNPA"), 22 U.S.C. § 287c; Cuban Democracy Act ("CDA"), 22 U.S.C. § 6001–10; The Cuban Liberty and Democratic Solidarity Act ("Libertad Act"), 22 U.S.C. § 6021–91; The Clean Diamonds Trade Act, Pub. L. No. 108-19; Foreign Narcotics Kingpin Designation Act ("Kingpin Act"), 21 U.S.C. § 1901–1908, 8 U.S.C. § 1182; Burmese Freedom and Democracy Act of 2003, Pub. L. No. 108–61, 117 Stat. 864 (2003); The Foreign Operations, Export Financing and Related Programs Appropriations Act, Sec. 570 of Pub. L. No. 104-208, 110 Stat. 3009-116 (1997); The Iraqi Sanctions Act, Pub. L. No. 101-513, 104 Stat. 2047-55 (1990); The

payment account data are also subject to state laws governing notification to customers and state entities when that personal information is compromised.[10] Finally, although the full scope is still being fleshed out, the Consumer Financial Protection Bureau has supervisory authority over certain "covered persons," including nonbanks.[11]

THE CALIFORNIA MONEY TRANSMISSION ACT

Since the recent overhaul of the MTA in 2010, California companies and other stakeholders have struggled to understand the explicit requirements of the statute, which are, at times, vague and open-ended. These challenges have been compounded by the absence of published regulations from the Department of Financial Institutions' ("DFI") interpreting the MTA. The need for interpretive regulations is partially a product of the statute. In its current form, the MTA does not define many of its key terms, and even where terms are defined, the statutory definitions are vague and, in at least two instances, circular.

What is "money transmission"? Ironically, one of the statute's key terms—money transmission—suffers from a vague and circular definition that offers almost no guidance to any company seeking to determine whether it is regulated under the MTA. The statute defines "money transmission" as "[r]eceiving money for transmission."[12] It later defines "receiving

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International Security and Development Cooperation Act, 22 U.S.C. § 2349 aa8–9; The Trade Sanctions Reform and Export Enhancement Act of 2000, Title IX, Pub. L. No. 106-387 (October 28, 2000).

[10] At this time, forty-six states, the District of Columbia, Puerto Rico, and the Virgin Islands have enacted such statutes. The National Conference of State Legislatures publishes a comprehensive list, *available at* http://www.ncsl.org/issues-research/telecom/security-breach-notification-laws.aspx. Such firms must also comply with industry standards set by the PCI Security Standards Council, *available at* https://www.pcisecuritystandards.org.

[11] *See* 12 U.S.C. § 5514(a)(1)(C).

[12] Cal. Fin. Code § 2003(o)(3). Also included within the definition of "money transmission" are the activities of "[s]elling or issuing payment instruments," and "[s]elling or issuing stored value." Cal. Fin. Code § 2003(o)(1), (2).

money for transmission" as "receiving money or monetary value … for transmission … ."[13] This last phrase, if read literally, appears to embrace every person, household, and company in California. Everyone receives money from some and delivers it to others.

Who must obtain a license, and who is exempt? Another source of confusion in the current version of the statute is the provision stating that certain companies may qualify for exemption. The MTA authorizes the Commissioner of DFI to exempt certain entities from the statute's licensing requirements, if he or she "finds such action to be in the public interest and that the regulation of such persons or transactions is not necessary."[14] The statute does not define or provide guidance as to when the granting of an exemption is considered to be "in the public interest," and this omission has created a great deal of confusion in the industry.

While it is clear that DFI has exercised this authority and granted exemptions to certain unspecified firms, DFI has not made publicly available any explanation as to how or why it has exercised this authority in some instances but not others. Recently, DFI has released a limited number of its letters and memoranda issued in response to requests for advice or opinions regarding its interpretation and enforcement policies under the MTA.[15] This limited release of its opinion and advice letters indicates that DFI believes that the "public interest exemption" covers at least three categories of firms: (1) agents of an FDIC-insured bank; (2) companies that are subject to regulation by another California agency; and (3) firms that fall outside DFI's interpretation of "money transmitters." Moreover, these letters indicate that DFI has interpreted "not necessary" to mean duplicative of (or overlapping with) another licensing regime. But

[13] Cal. Fin. Code § 2003(s).

[14] Cal. Fin. Code § 2011.

[15] *See* http://www.dfi.ca.gov/legal/default.asp (explaining that the selected group of letters may not necessarily be in line with current Department policy, warning against reliance on the published letters, and reserving the right to qualify, withdraw or retract any of the letters).

informal standards are not available within the statute, and these interpretive letters provide no sound policy or regulation under which stakeholders may determine whether they are operating within a permissible zone of exemption.

What must a prospective licensee do in order to obtain a license? The proposed amendments to Section 2040(a) of the Financial Code create two classes of MTL applicants: those who must possess and maintain a minimum net worth of between $100,000 and $500,000, and those who must maintain up to $2 million "if the commissioner determines with respect to the applicant or license holder, that a higher net worth is necessary to achieve the purposes of this division." The proposed amendment goes on to list eleven factors the Commissioner should use to make the determination that a higher net worth is required.

Although this revision appears to provide some additional clarity, it places the discretion to grant exemptions wholly within the hands of DFI. This may lead to the same problems that have plagued its prior administration of the exemption provision. In the past three years, DFI has not issued any public regulations explaining what it has concluded a prospective licensee must do to obtain an MTL—in particular, the necessary amount of shareholders' equity required for each applicant. In other instances, companies have reported that DFI has required them to have shareholders' equity in excess of $500,000 threshold set by the statute. This capital requirements are in addition to the already onerous requirements that applicants obtain a surety bond somewhere in the range of $250,000 and $7 million, and pay an annual license fee of at least $2,500.[16] The lack of transparency and certainty with regard to the obligations has slowed innovation and is likely to continue to do so unless the MTL application requirements are made more explicit.

[16] Cal. Fin. Code § 2037(c)–(e).

DFI Has Not Issued Interpretative Regulations

To date, the challenge of reconciling the MTA with rapidly evolving technology and the web of regulation facing California companies has fallen to DFI. The Legislature has authorized DFI to administer the MTA and to issue interpretive regulations. But in the three years that have elapsed since the California legislature enacted the MTA, DFI has yet to issue a single regulation.[17]

DFI's failure to subject its interpretations of the MTA to notice-and-comment rulemaking has deprived it of a wealth of expertise and information that could be brought to bear on the challenging issues underlying the MTA. Moreover, entrepreneurs and businesses seeking to expand into the payment business do not know whether they need to obtain a license from DFI or whether their activities are exempt from regulation. Where so much is at stake for private industry, an open rulemaking process is certain to attract talent and energy commensurate with the complexity and significance of the issues. This promises a quality resolution for the state of California. And, as so often in the past, California's solution could provide an example for other states and the nation as a whole.

SUGGESTED IMPROVEMENTS

I would recommend that the Committee consider making changes to the current MTA regime that would reduce uncertainty, increase transparency and relieve concerns about inconsistent enforcement of the statute that have been reported among the industry and other stakeholders in the past few years. These improvements include revising and creating new statutory definitions, allowing for reciprocity of money transmission licenses, and creating a pilot

[17] In January of this year, DFI publicly announced its intention to issue regulations, but that effort is likely to be stalled further in light of the impending revisions to the MTA.

program to allow companies to test new money transmission concepts without needing to obtain an MTL.

New and Revised Definitions

As noted above, many of the MTA's statutory definitions are vague and, in some cases, circular. I would recommend that the Legislature take this opportunity to write more detailed definitions for the term "money transmission" and/or "receiving money for transmission."

The Legislature should also consider creating a statutory definition (or set of definitions) clarifying the scope of the act. Leaving this decision solely up to the discretion of the Commissioner, under a standard as vague as "in the public interest," has not proven to be an effective solution thus far. Clarifying the expectations and obligations of both regulator and the regulated would benefit all. To that end, I would also recommend a statutory requirement that DFI publish a list of companies that have applied for, and received, an exemption under the statute. Under the current regime, DFI only publishes information about new applicants and licensees, but information about companies that have been administratively recognized as exempt from the requirements of the MTA is unavailable to the public. This has led to confusion and distrust among the relevant stakeholders, with some companies informally reporting that they have been granted exempt status but without any formal recognition of that status.

Along these lines, I would recommend that the Legislature consider a statutory exemption covering entities that operate under the "payee-agent" model. Some states explicitly recognize a relationship through which a financial institution acts as the agent of the payee as grounds for exemption from money transmission regulation. For example, New York's money

transmission statute explicitly exempts agents of "payees" provided there is an agency agreement that ensures that the "payors" bear no risk of loss if the agent fails to remit the funds.[18]

The idea behind the "payee-agent" model is that payment to the agent is deemed payment to the payee. For instance, the New York State Banking Department authorized this exemption under the reasoning that if there is no risk of loss to the payor in the event the agent fails to remit the funds to the payee, then there is no greater risk than if the funds were tendered by the customers directly to the payees.

Two other states, Nevada and Ohio, also explicitly recognize the payee agent exemption (and it is likely that other states implicitly recognize the payee agent exemption). Nevada's Issuers of Instruments for Transmission or Payment of Money statute provides: "A person shall not engage in [the business of receiving for transmission or transmitting money] as an agent except as an agent of a licensee *or a payee*."[19] Similarly, Ohio's Money Transmitters statute provides that money transmission does not include "transactions in which the recipient of the money or its equivalent is the principal or *authorized representative of the principal* in a transaction for which the money or its equivalent is received."[20]

Similar to these states, California should consider including an explicit "payee-agent" exemption in the MTA. The basic purpose of money transmitter regulation is to protect consumers in the event that an intermediary holding funds payable to a third party defaults on that obligation. That risk is not present when an intermediary (B) holds funds transferred from a consumer (A) that are payable to a third party (C), and the receipt of funds from A to B is deemed to extinguish A's obligation to C.

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[18] *See* N.Y. Banking Law § 641.1.

[19] Nev. Rev. Stat. Ann. § 671.040 (emphasis added).

[20] Or. Rev. Stat. § 1315.01 (emphasis added).

Reciprocity Program

I would also suggest that California (and other states) eliminate the requirement that an entity must be licensed by all 50 states to operate nationally. There is no apparent benefit, from a prudential standpoint, of such a fragmented regulatory regime. This is not to say that licensing itself has no value—as in the banking industry, some supervision likely helps ensure that electronic payment companies can meet their obligations to consumers. This value becomes diluted, however, when that company must contend with the overlapping, but not identical, regulatory requirements across the 50 states. In other contexts, state-regulated entities are able to "passport" a single state license across all 50 states, so that compliance with that individual state's regulations suffices to allow those entities to do business nationwide.[21]

Accordingly, I would recommend that the Legislature consider a reciprocity program that allows companies already licensed in other states to engage in money transmission activities in California so long as certain requirements were satisfied, *e.g.*, assurance that the company meets the California MTA's capital thresholds and files a certification with California DFI.

Pilot Program

Finally, I would propose that the Legislature consider creating a new pilot program available under the MTA that would offer a temporary exemption for companies seeking to pilot in-state money transmission programs. Qualification for the program would be subject to statutorily defined constraints, *e.g.*, limitation on the duration and size of the program, segregation of customer funds from operating funds, compliance with applicable Federal money

[21] For example, under the Federal Secure and Fair Enforcement for Mortgage Licensing Act ("SAFE Act"), 12 U.S.C. § 5100 *et seq.*, mortgage loan originators enjoy uniform licensing standards nationwide, either through their home states' participation in the Nationwide Mortgage Licensing System and Registry or by those states' establishing individual systems that comply with certain federal standards.

laundering requirements, and registration with DFI 30 days prior to inception of the pilot.[22] Once the pilot program exemption status came to an end, the company would have the option of either (1) applying for an MTL or (2) seeking exempt status from DFI, through a separate application or otherwise. Those applications and their disposition would subsequently be made publicly available after DFI had made a determination as to the applicant's licensing, or exempt status.

CONCLUSION

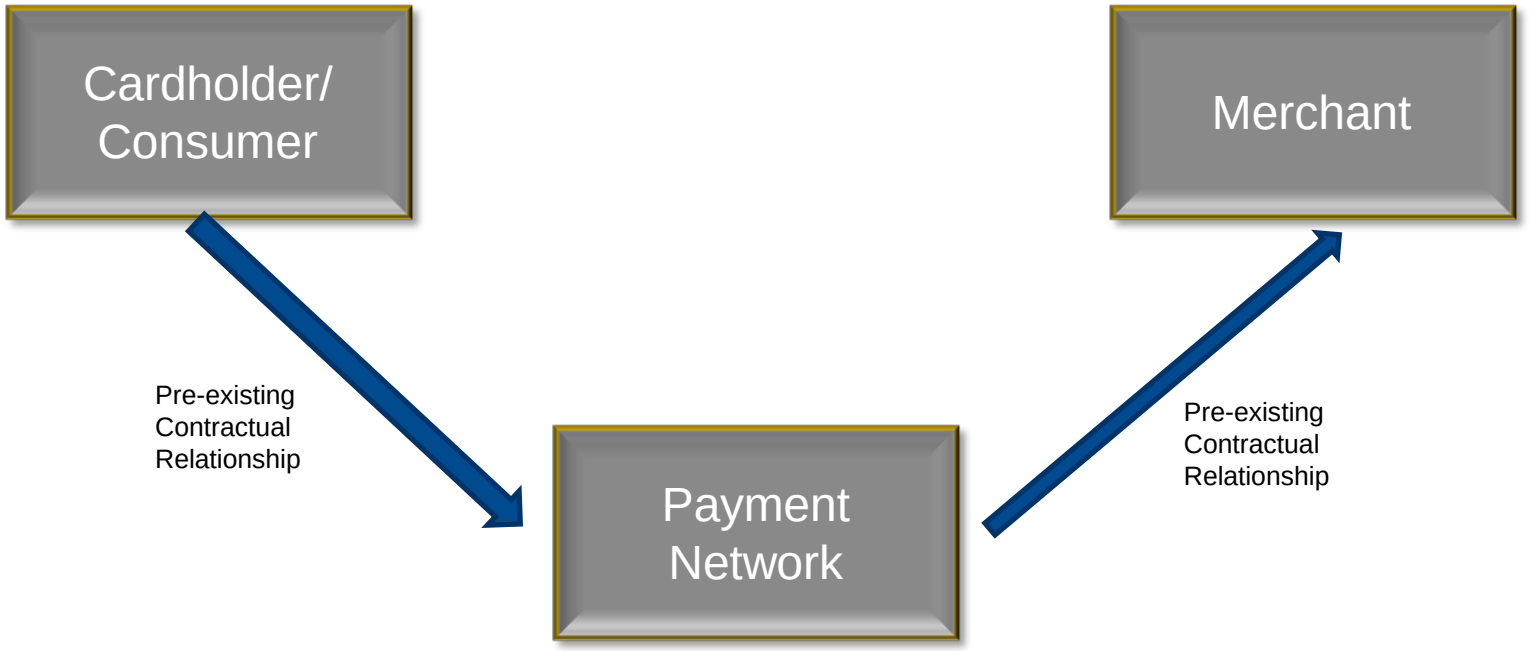
This is an exciting time for the payment industry. Emerging technologies are creating opportunities for financial institutions, merchants and consumers to reinvent commerce. The Legislature should keep this in mind in its effort to amend California's MTA, a statute that has created confusion and uncertainty, threatening to stifle the innovation for which this State is known. Through certain improvements and clarifications, the MTA can both operate to protect consumers from risk of loss, as well as serve the electronic payments companies that are creating innovations serving those consumers.

Thank you again for inviting me to appear today. I am happy to answer any of the committee's questions.

[22] Texas has a temporary license regime that is directionally consistent, though much more limited than this proposal. *See* Tex. Fin. Code § 151.306.

APPENDIX 2

Contractual Flow for Payments



Contractual Flow for Money Transmission

PAUL HASTINGS

When Money is Sent

When Money is Received