

MEMORANDUM

To: Cyberpayments Working Group of the Uniform Money Services Business Act
Drafting Committee
Bion Gregory, Chair
Sarah Jane Hughes
Nicholas Kyrus
Ezra Levine
Joseph Sommer
Russell Stevenson, Jr.

From: Anita Ramasastry

Re: Issues to be considered by the Working Group

Date: January 5, 2000

The questions that the cyberpayments task force may want to consider include¹:

1. What (if any) new payment mechanisms might be included within the scope of the UMSBA? Included in this are stored-value cards, electronic currency, and on-line bill payment services. Subsidiary questions include whether any of these new payment mechanisms pose safety and soundness concerns or money laundering concerns when non-bank issuers/sellers are involved?
2. Should the current definition of stored-value instrument be amended
3. To the extent that Internet-based payment mechanisms (e.g., on-line bill payment services) are included within the definition of a money-services business, what jurisdictional concerns arise and how should the UMSBA deal with such

¹ Previously, questions had been phrased in the following manner:

- Are these payment systems or businesses similar to money services businesses to be grouped together in the UMSBA?
 - If the answer to Question One is yes, do non-bank issuers who may provide such services pose safety and soundness concerns that might be addressed via the UMSBA?¹
 - If the answer to Question One is yes, do non-bank issuers who may provide such services pose possible money laundering concerns that might be addressed via the enforcement and reporting provisions of the UMSBA?
- To the extent that such entities/businesses are included within the scope of the UMSBA -- what differences should exist in the way such entities are licensed? For example, will such an entity have to be licensed in 50 States despite having an Internet presence?

problems? (e.g. creating a possible home licensing state for licensing purposes)

As part of this analysis, the Working Group may need to consider the following types of materials and information:

1. Current state amendments to or interpretation of existing money transmission statutes to include stored-value/electronic payment instruments.²
2. Secondary material which explains the way in which different types of payment mechanisms and cases addressing approaches to jurisdiction on the Internet.

I. Types of Payment Mechanisms to be considered by the Working Group

A. Stored-value

Stored-value products are a recent innovation in payment systems technology. Stored-value products possess certain basic characteristics. According to the Federal Reserve, stored-value products share three attributes: "(i) [a] card or other device electronically stores or provides access to a specified amount of funds selected by the holder of the device and available for making payments to others; (ii) the device is the only means of routine access to the funds; and (iii) the issuer does not record the funds associated with the device as an account in the name of (or credited to) the holder."

Stored-value cards are also known as "smart" cards, prepaid cards, or value-added cards. These cards maintain on a computer chip a stored-value of funds available to be used by a person for various types of retail transactions. A balance is recorded on the card which is debited at a point-of-sale terminal when a consumer or individual makes a purchase. Typically, a consumer will pay a bank or other provider money in exchange for a card that is loaded with value. The consumer uses the card rather than paper currency to purchase good and services. Merchants who accept smart cards can transfer the value of accumulated credits to their bank accounts. A smart card is not typically used for transactions over the Internet. Several new services, however, provide for remote payments to be made by electronic currency that is stored on the hard drive of a person's computer.

When discussing stored-value, commentators refer to "closed" and "open" systems. A closed system is one where the stored-value card can be used only for goods and services provided directly by the card issuer. For example, a university may issue a stored-value card which students may use to purchase books, cafeteria food, and fares on the university's bus system. An "open" system is one where the issuer is not the provider of goods and services but is perhaps part of a group of issuers whose stored-value cards are accepted as a form of payment by a host of merchants.

The transfer of stored-value may provide an opportunity for money laundering. The

² We have sent out a general letter of inquiry to state regulators on this point

amount of value that can be retained on a stored-value card will, of course, affect whether people will use these products for money laundering. If one can store a large amount of value on a card that is highly portable and transferable, this will increase the likelihood of money laundering. Stored-value and electronic currency may give people the ability to move money globally without using banks as intermediaries. Theoretically, funds can be transferred to jurisdictions with less stringent money laundering laws via a stored-value instrument or over the computer. A smart card encoded with a large amount of electronic money can be slipped into a person's pocket and taken anywhere in the world.

Several States have begun to include stored-value within their existing money transmission law. Connecticut, for example, has defined stored-value as a form of "electronic payment instrument." This term would also include electronic traveler's checks. Other States, such as Texas, have included stored-value providers by interpretation. West Virginia defines "currency transmission" or "money transmission" to include "the transmission of funds through the issuance and sale of stored-value cards which are intended for general acceptance and use in commercial or consumer transactions."

The Texas Banking Department has explained, for example, its rationale for requiring nonbank issuers of open system stored-value cards to obtain a license under the Texas Sale of Checks Act:

Stored-value cards issued by non-banks for use in "open" systems (i.e., to purchase goods and services offered by vendors other than the issuer of the card) will generally be subject to regulation under the Sale of Checks Act because the non-bank issuer is holding the funds of third parties. Consumers are relying on the non-bank issuer that the card will be honored when presented by the purchaser of goods and services at diverse locations.³

Oregon is the most recent state to include a provision for the regulation of stored-value. Section 2 of the Sale of Checks Act includes a definition of electronic instrument which "means a card or other tangible object for the storage of information, that is pretended and for which the value is decrement upon each use." The term excludes "a card or other tangible object that is redeemable by the issuer in the issuer's goods and services."⁴

At the October 1998 meeting, the Drafting Committee affirmed its decision to include stored-value products and stored-value providers within the scope of the Act. Drafting Committee members saw the use of stored-value as a means of payment as similar to money transmission. Therefore, to the extent possible, the Drafting Committee recommended including stored-value within existing definitions of payment instruments. The Committee has made the following decisions with respect to stored-value:

³ A Summary of Recent Electronic Banking and Money Transmission Developments in Texas , prepared by Jerry G. Sanchez, Assistant General Counsel, Texas Department of Banking (1997), at 1.

⁴ 1999 Oregon Laws Ch. 571 (S.B. 690) (West Group 1999).

- stored-value is defined as a form of electronic payment instrument and thus the sale of a stored-value instrument constitutes the sale of a payment instrument for purposes of UMSBA;
- non-bank issuers of stored-value have been exempted from the licensing requirements of the UMSBA if they are subjects by a federal or state-banking regulator to a safety and soundness regime that addresses investment and capital requirements.⁵
- stored-value issuers, sellers and redeemers are treated as payment instrument sellers; payment instrument sellers, in turn, are subsumed under the definition of money transmitters, thereby triggering the Article 2 licensing provisions of the UMSBA;
- closed-end stored-value instruments such as phone cards or metro cards are not included within the definition of stored-value instrument; and
- stored-value issuers that are subject to supervision and oversight by a federal or state banking agency are also exempt from the licensing provisions of the Act.

The Working Group should examine the existing definition of stored-value and stored-value instrument to determine whether they are appropriately drafted. Some observers have noted that the term “stored-value instrument” focuses on the use of the card rather than on the concept of the “value” itself. Additionally, the Drafting Committee has raised concerns about the criteria used for exempting certain non-bank issuers of stored-value, from licensing and regulation under the UMSBA.

B. Internet Payment Mechanisms

New types of cyberpayments or Internet payment mechanisms have been referred to by regulators and commentators by a host of different names including electronic cash, digital cash, electronic currency, and internet or on-line scrip (“E-money”) E-money refers to money or a money equivalent that is transformed into information stored on a computer ship or a personal computer so that it can be transferred over information systems such as the Internet. Technology permits the transmission of electronic value over networks that link personal computers (PCs) and the storage of electronic cash on the hard drives of personal computers.

One of the main issues that the cyberpayments Working Group needs to consider is whether a payment service provider is actually holding funds received from consumers for its own account and has redemption obligations to consumers. To the extent that a service provider

⁵ United States Department of Treasury, An Introduction to Electronic Money Issues: Toward Electronic Money and Banking: the Role of Government (1996), at 8; GAO Report on Payment, Clearance and Settlement: A Guide to the Systems, risks and Issues (June 1997), at 139.

has outstanding obligations to consumers (that might not be honored in the event of the entity's insolvency), safety and soundness issues may arise.⁶

There are two primary methods by which a consumer can make payments over the Internet. The first type is through use of a traditional payment method such as ACH or credit card. The Internet serves as a mode of communication only.

The second type of Internet payment mechanisms involve "E-Money". One type of Internet-based E-money system has been described as a token or notational system.⁷ These computer-based systems involve a customer purchasing electronic tokens, which serve as cash substitutes for transactions over the Internet. With this type of system, "money" or "value" is purchased from an issuer (who may be bank or a nonbank). The value is then stored in a digital form on a consumer's personal computer and the notational value is transferred over the Internet. The "coin" is merely a notational series of numbers or other symbols that are transmitted over the Internet to a merchant. The merchant must then redeem the "coin" with an issuer – who will verify that the coin has not been spent previously.. The issuer of the Internet E-Money or "scrip" is obligated to redeem these payments when received from the merchant.⁸

⁶ In a 1996 report on emerging electronic methods for retail payments, the United States Congressional Budget Office noted that:

[T]he supervision and regulations covering depository institutions safeguard the safety and soundness of those institutions. Lacking those safeguards, an electronic payment method issued by an unregulated institution is more likely to fail. Such a failure could undermine consumers' confidence in other issuers. Thus, the best interest of the payment system may be served by having safeguards in place to protect it from consequences of the failure of individual institutions

Emerging Electronic Methods for Making Retail Payments, Congressional Budget Office (June 1996), at 42.

⁷ For a useful discussion of account-based and notational or token-based systems See Letter from Russell B. Stevenson, Jr., General Counsel, Cybercash to Office of the Legal Counsel, Financial Crimes Enforcement Network, (September 29, 1997). Cybercash notes:

Electronic payment systems can be divided into two general classes: "account-based" or "notational" systems or "token-based" systems. Account-based systems use secure electronic communications to transfer funds among accounts in traditional financial institutions. Because they make use of the existing financial infrastructure, transfers using account-based systems create an audit trail that is essentially identical to the audit trail created by traditional institutions in the banking system. In contrast, token-based systems make use of digital "tokens", which are very large numbers generated through cryptographic techniques. An issuer, which is usually, but not necessarily a bank or other financial institution, issues or "validates" these tokens and sells them to users, transferring the validated tokens to computer disks or other forms of electronic storage media. These tokens become, in effect, digital bearer instruments that they represent value. They can be transferred anonymously from one user to another until themselves are eventually presented to the issuer for redemption.

⁸ As noted in a recent paper authored by an economist at the Federal Reserve Bank of Kansas City:

To make a digital-cash purchase, a customer must first use the software to initiate a transfer of funds from the deposit account to a personal computer. The software proceeds to create digital currency -- either coins

Commentators have noted that state money transmission statutes may, by implication, include or regulate Internet payment systems such as the notational systems described above. Others have suggested that in the future might be a source of prudential regulation for non-bank entities engaged in this activity.⁹ For example, The United States Consumer Electronic Payments Task Force has noted:

Many commentators have informed the Task Force that they were concerned that e-money issuers would become insolvent, and that consumers would not be informed of their rights in the event of such an insolvency *****

Other nonbank issuers may be subject to state regulatory oversight; however, the extent of this supervision is unclear. Clarification by state regulators and legislatures of the applicability of their laws to e-money could be beneficial.¹⁰

Token or notational systems may involve exchange of value that is not redeemable in money. For example, the term “scrip” has been used to refer to value that may be exchanged over the Internet but which may not be redeemable for money. Scrip is more analogous to

or notes. The digital coins and notes have no physical representation. Each is just a unique random number with a denomination, or value, assigned to it. The software decides which denominations to create. To effect the transfer, the software instructs the bank to withdraw funds equal to the value of the currency from the customer's account and to validate the coins and notes by signing them digitally. The digital signature resembles a handwritten signature, The software hides the customer's identity during the validating process so the bank can never associate the customer with the coins.

The customer can now make a purchase from an Internet-based merchant or another individual that has the necessary software. The customer simply decides what to buy and instructs the computer to send currency electronically as payment. When the currency arrives, the recipient's software verifies the bank's digital signature and that the currency has not been spent already. Once the recipient knows the currency is valid, it can deliver the customer's purchase. The recipient can transfer the currency received to its bank account or store the currency in its computer's memory for later use. . . .

Like stored-value cards, digital cash is from the consumer's perspective, comparable to coins and paper notes, only for purchases in cyberspace. But because of the verification required, purchases with digital cash require a third party's involvement. So far, the third parties are banks that have licensed digital cash software, but that need not be the case.

Stacey L. Schreft, Looking Forward: The Role of the Government in Regulating Electronic Cash, Federal Reserve Economic Review (Fourth Quarter 1997), at 61-62

⁹ See, e.g., Stacey L. Schreft, Looking Forward, at 76 and footnote 39 (referring to traveler's check regulations concerning permissible investments as a possible comparison); Board of Governors of the Federal reserve System, Report to the Congress on the Application of the Electronic Funds Transfer Act to Electronic Stored-Value Products (March 1997), at 67; Report of the United States Electronic Consumer Payments Task Force (April 1998), at 40-45; GAO Report, Payment Clearance and Settlement: A Guide to the Systems, Risks and Issues (June 1997), at 139 and 161; Journal of Internet Banking and Commerce (<http://www.arraydev.com/commerce/jibc/9702-17.htm>), at 7.

¹⁰ Report of the Consumer Electronic Payments Task Force (April 1998), at 44.

coupons or bonus points that can be exchanged by a consumer for goods or services but have no cash redemption value. Scrip can be used by merchants to sell access to value-added Web pages on a per-access basis or a subscription basis. They can also use scrip to provide promotional incentives to users. Scrip can represent any form of currency, points in a frequent user program, access rights, etc.

In addition to token or notational systems, there are also “account-based” E-money systems. Account-based systems involve a consumer purchasing “E-money” by debiting an existing bank account or using a credit card to buy “coins”. The Internet is a place where the value may be stored and then used for transactions. The merchant who accepts the E-money ultimately redeems the account-based E-money with a bank or credit card company.

C. Internet Bill Paying Services

Banks and nonbank have begun to offer Internet bill paying services. For a fee, electronic bill payment services pay certain bills for consumers, after receiving authorization from a consumer. The customer accesses the service via the Internet. Bill payments may subsequently be made for the consumer electronically. Typically, the service provider will use an Automated Clearinghouse (ACH) transfer to effectuate payment. However, if the designated payee does not accept electronic payment, the bill-paying service will print and mail a check on behalf of its customer.¹¹ When a nonbank service is involved, the nonbank has no contractual relationship with the consumer's bank. Instead, the consumer's bank will transfer money to the bill-paying service company. The bill-paying service will, in turn, deposit the funds into its own bank account. The bill-paying service will then issue a payment instrument payable on its own account to the designated payee.

The Texas Department of Banking has required at least one bill-paying service, CheckFree, to obtain a license under its Sale of Checks Act. Texas made this decision based on the fact that the bill-paying service was holding the money of consumers in its own account and issuing payment instruments to merchants payable on the same account.¹² The Texas Sale of Checks Act defines a check to include “an instrument for the transmission or payment of money, including a draft, traveler's check, or money order. The term also includes an instrument for the transmission or payment of money in which the purchaser or remitter of the instrument appoints or purports to appoint the seller as its agent for the receipt, transmission, or handling of money, regardless of who signs the instrument.”¹³ Texas is currently assessing the situation with several other Internet bill-paying services. California may also have required an Internet bill-paying service to obtain a license under its relevant statute. By implication, bill payment services may already be included within

¹¹ See GAO Report, Payment Clearance and Settlement: A Guide to the Systems, Risks and Issues (June 1997), at 143-144.

¹² Reporter Conversation with representative from Texas Banking Department (October 20, 1999)

¹³ Sec. 152.002 of Texas Sale of Checks Act.

various sale of instruments or money transmission statutes.

II. Internet Jurisdiction

The issue of Internet jurisdiction is an areas where there has been increasing litigation and commentary. In the United States, for determining whether personal jurisdiction can be exercised over a defendant whose only contact with the state is through the internet, courts have evaluated the nature of the internet web site and the quality of the commercial activity conducted.¹⁴.¹⁵ Where a defendant clearly is doing business by entering into business contracts that involve repeated and knowing transmission of data over the internet, personal jurisdiction is proper. Where a defendant's web site merely advertises the defendant's product, personal jurisdiction usually is inappropriate. Where the defendant's web site allows a user to exchange information with another computer, jurisdiction is determined by the level of interactivity and by the commercial nature of the information exchanged.

Courts, when determining whether jurisdiction is appropriate, look to the nature and quality of the commercial activity that a defendant conducts over the internet The Western District of Texas, in an internet gambling case, stated the sliding scale discussed in *Zippo* that courts have used is consistent with personal jurisdiction principles.¹⁶ The court described the sliding scale as:

At the one end are situations where a defendant clearly does business over the Internet by entering into contracts with residents of other states which involve in the knowing and repeated transmission of computer files over the Internet. At the other end are passive Web site situations. A passive Web site that solely makes information available to interested parties is not grounds for the exercise of personal jurisdiction. Interactive Web sites, where a user can exchange information with the host computer, represents the middle ground. In these cases, the exercise of jurisdiction is determined by examining the level of interactivity between the parties on the Web site.¹⁷

In *Thompson*, the court held that jurisdiction was appropriate since the defendant had continually interacted with casino players, entering into contracts with them to play the various games and knowing full well that he would receive commercial gain through these contracts. Moreover, those who played the casino games did so as if the games were physically located in Texas, and if a party should win, the defendant would send the winnings to that person in Texas.

Courts have also looked to the intent to attract users to employ their services, which then leads to bilateral contacts. The Court of Appeals in Minnesota affirmed jurisdiction over a defendant who had advertised a forthcoming on-line gambling service and had compiled a

¹⁴ *Zippo Manuf. Co. v. Zippo Dot Com, Inc.*, 952 F.Supp. 1119, 1124 (W.D. Pa. 1997), cited by *David Mink v. AAAA Development LLC*, 190 F.3d 333, 336 (5th Cir. 1999)

¹⁶ *Thompson v. Handa-Lopez, Inc.*, 998 F.Supp. 738, 742 (W.D. Tx 1998).

¹⁷ *Id.*

mailing list that included Minnesota residents.¹⁸ N.W.2d 715, 717 (Minn. Ct. App. 1997), *aff'd*. The court reasoned that internet advertisements are similar to direct mail solicitation in that advertisers distribute messages to internet users; users must take affirmative steps to receive the advertised product.¹⁹ The contacts, thus, are not unilateral. Here the web site indicated the company's intent to seek customers from a broad geographic area that included Minnesota by stating that it was "open to International markets."²⁰ The court then employed a five factor test to determine the constitutional validity of the state exercising personal jurisdiction: quantity of contacts, nature and quality of contacts, relatedness between the contacts and the cause of action, interest of the state, and convenience of the parties.²¹ Since the defendant had a clear intent to solicit business from internet users in Minnesota and 248 contacts in a two week period were registered, including at least one successful solicitation, and since the cause of action arose out of these contacts and the state had an interest in regulating gambling, jurisdiction was appropriate.²²

Steven Betensky's article/speech, *Jurisdiction and the Internet*, 19 Pace L. Rev. 1 (1998), reviews how courts have approached exercising jurisdiction and the internet. He describes three approaches to jurisdiction and the internet, and these three approaches were highlighted in *Zippo Manufacturing Co.* The three approaches are: (1) contracts entered into through a web site; (2) cases involving interactive sites; and (3) cases involving passive web sites. Generally speaking, cases involving contracts where there is repeated transmission of information, jurisdiction is proper.²³ Cases involving pass web sites, such as advertisements with noting more, jurisdiction is not appropriate.²⁴ Cases involving interactive web sites, a web site where information is exchanged, jurisdiction depends on the nature and quality of the contacts.²⁵

Betensky lists seven factors that have been considered when determining whether jurisdiction is appropriate for interactive web sites: (1) does the site require registering or signing on to the web site; (2) have agreements been entered into through the web site; (3) is e-mail available; (4) has the site been accessed by users located in the forum; (5) is the site commercial in nature; (6) does the site solicit sales through the site and is there a contract; and finally, (7) is the site primarily local or does it serve a national market.²⁶ These factors have also been applied for determining whether a site is passive or interactive.²⁷ The distinction between passive and interactive web sites is not entirely clear as courts have weighted these factors differently.²⁸

Richard Philip Rollo's casenote, *The Morass of Internet Personal Jurisdiction: It is Time*

18 *Humphrey v. Granite Gate Resorts, Inc.*, 568 N.W.2d 747 (Minn. 1998).

19 *Id.* at 720.

20 *Id.*

21 *Id.* at 721.

22 *Id.* at 722.

23 *See e.g., CompuServe, Inc. v. Patterson*, 89 F.3d 1257 (6th Cir. 1996).

24 *See e.g., Cybersell, Inc. v. Cybersell, Inc.*, 130 F.3d 414 (9th Cir. 1997) (service mark infringement case).

25 *See Zippo*, 952 F.Supp. at 1124.

26 Betensky, at 11-13.

27 *See Cybersell*, 130 F.3d at 419

28 Betensky, at 16.

for a Paradigm Shift, 51 Fla. L. Rev. 667 (1999), discusses internet jurisdiction in relation to the Supreme Court's approach to personal jurisdiction: i.e., stream of commerce or stream of commerce plus. The note refers to *Humphrey v. Granite Gate Resorts*, 568 N.W.2d 715, 717 (Minn. Ct. App. 1997), *aff'd* 576 N.W.2d 747 (Minn. 1998) (internet gambling) and *Zippo Manufacturing Co.*, supra.

Stomp, Inc. v. Neato, LLC, 61 F.Supp.2d 1974 (C.D. Cal. 1999), a patent infringement case, likewise refers to *Zippo's* continuum and finds that the commercial nature of the web site supports establishing jurisdiction over the defendant. *Id.*, at 1078. The use of the web site placed products into the stream of commerce. Moreover, Neato intended consumers to purchase its products via the internet. *Id.* Therefore, by using the internet with the intent to engage in commerce and actually doing so, Neato established the minimum contacts that are a prerequisite to jurisdiction. *Id.*

Resuscitation Technologies, Inc. v. Continental Health Care Corp., 1997 WL 148567 (S.D. Ind. 1997) (with reference to *Zippo*, personal jurisdiction exercised due to the numerous and continuous use of email messages over a period of several months). The court stated: "[t]he quality of those electronic contacts is measured with reference to the intended object of that activity." *Id.* In this case, the parties communicated via email and regular post, and had face-to-face meetings out of state. All of which were intended to negotiate a commercial agreement to transact business. Since the parties intended to transact business and exchanged several email messages, jurisdiction was appropriate.

III. Relevant Websites

A. Cyberpayments Links

<http://www.ecashtechologies.com>

<http://www.stls.frb.org/fspc/eleccurr.pdf>

<http://cla.org/Publications/RuhBook/chp8.htm>

<http://www.gao.gov/AIndexFY97/abstracts/gg97073.htm>

<http://www.itas.fzk.de/deu/tadn/tadn298/coat298a.htm>

<http://www.occ.treas.gov/emoney/ceptfpap.htm>

<http://www.abanet.org/buslaw/efss/home.html>

http://www.banking.com/aba/cover_0998.asp

<http://www.smu.edu/~jwinn/clashoftitans.htm>

<http://robotics.stanford.edu/users/ketchpel/ecash.html>

http://www.chi.frb.org/paysys/database/other_Resources.html#Ecash

B. Jurisdiction Links

<http://www.ilpf.org/confer/present99/>

<http://miser.suffolk.edu/law/hightech/classes/cyberlaw/sjensen/paper.htm>

<http://www.unc.edu/courses/law357c/cyberprojects/spring98/dewey/cyber.html>

<http://www.uottawa.ca/~geist/jurisdiction.html>

<http://www.jmls.edu/cyber/index/juris.html>

<http://www.cyber.findlaw.com/jurisdiction>