

MEMORANDUM

To: Members of the Drafting Committee and Observers
Uniform Money Services Business Act ("UMSBA")

From: Anita Ramasastry, Reporter

Re: Issues for consideration concerning Internet payment mechanisms

Date: October 19, 1999

The following is a brief memorandum describing some of the Internet payment mechanisms that the Drafting Committee might consider for potential inclusion within the scope of the licensing provisions of the UMSBA.

A. Stored value

Stored-value instruments have been more fully considered by the Drafting Committee and certain non-bank issuers of stored value are included within the licensing provisions of the UMSBA as money transmitters. A stored-value instrument, furthermore, has been defined in the UMSBA as a payment instrument.¹ Non-bank issuers of stored value have been exempted from the licensing requirements of the UMSBA if they are subject by a federal or state banking regulator to a safety and soundness regime that addresses investment and capital requirements.²

As stated in the Reporter's notes to the UMSBA, states including West Virginia, Connecticut and Texas have recently amended their money services legislation to include stored-value/electronic-payment instruments within their statutes and subject to licensing requirements. The Texas Banking Department has explained, for example, its rationale for requiring non-bank 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

¹ See Sections 1-102(20), (22) and (28) in October 4, 1999 Draft of UMSBA
http://www.law.upenn.edu/bll/ulc/ulc_frame.htm

² 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.

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

B. Internet payment mechanisms

Regulators and commentators have referred to new types of cyberpayments or Internet payment mechanisms by a host of different names including electronic cash, digital cash, electronic currency, and Internet or on-line scrip.⁵ Digital currency or Internet scrip refers to money or a money equivalent that is transformed into information stored on a computer chip or a personal computer (PC) so that it can be transferred over information systems such as the Internet. Technology permits the transmission of electronic value over networks that link PCs and the storage of electronic cash on the hard drives of PCs.

As noted above, one of the main issues that the Drafting Committee needs to consider is whether a payment-service provider is actually holding funds received from consumers for its own account. To the extent that a service provider 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 an "account-based" system or account-transfer system.

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).

⁵ See, for example, Congressional Budget Office, Emerging Electronic Methods for Making Retail Payments (June 1996). The CBO Report refers to on-line scrip as an alternative to "on-line money" or "digital cash," explaining that "these terms are often potentially misleading because they are interpreted as being the same as money or cash, which has the backing of the U.S. government." By contrast, scrip connotes the "informal nature of the payment product; the value transmitted is no more than a representation of the issuer's promise to pay." Id. At 28.

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.

In this type of system, a customer instructs his or her bank to debit his or her account and to credit the account of the person receiving the payment. The Internet serves as a mode of communication but the clearance and settlement is effectuated between banks with the help of a third-party intermediary. On-line third-party payment servers are needed to process transactions between consumers and merchants in account-based transactions. With an account-based system, there is no new issuer of currency or value to be redeemed by the issuer. Rather, a financial institution is the entity that guarantees payment of a consumer's obligation.

The second type of Internet payment mechanisms 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 a bank or a non-bank). The value is then stored in digital form on a consumer's PC 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 "money" or "scrip" is obligated to redeem these payments when received from the merchant.⁸

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). Stevenson 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 to other forms of electronic storage media. These tokens become, in effect, digital bearer instruments in that they represent value. They can be transferred anonymously from one user to another until they 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 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. . . .

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 state money-transmissions statutes 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 non-bank 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

C. Internet bill-paying services

Banks and non-banks have begun to offer Internet bill paying services. For a fee, electronic bill-payment services pay certain bills for consumers, after receiving authorization from the consumer. The customer accesses the service via the Internet. Bill payments may subsequently be made for the consumer electronically. This type of payment system is analogous to writing a check. 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 non-bank service is involved, the non-bank 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

Like stored-value cards, digital cash is, from the consumer's perspective, comparable to coins and paper notes, only used 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.

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

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.

D. Possible questions to be asked about the mechanisms listed above:

1. Are these payment systems or businesses similar to money-services businesses to be grouped together in the UMSBA?
2. 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?¹⁴
3. If the answer to Question One is if 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?
4. 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?

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

¹³ Sec. 152.002 of Texas Sale of Checks Act.

¹⁴ See An Introduction to Electronic Money Issues, at 22. (Barring substantive changes in law, some electronic cash issued by non-banks will not be insured by the government against a loss due to issuer insolvency, although state statutes governing money transmitters may reduce the risk of issuer insolvency.)