

MEMORANDUM

To: NCCUSL Commissioners

From: Tom Bolt, Chair
Anita Ramasastry, Reporter

Date: June 15, 2000

Re: UMSBA – Matters Relevant to Consideration for Final Approval

NEED FOR UNIFORM RULES

The Uniform Money Services Business Act ("UMSBA" or "Proposed Act") is a uniform licensing law that addresses safety and soundness issues and provides regulators with an updated means of assessing whether a certain MSB should be permitted to engage in business within a state. There are several reasons why a uniform money services act is desirable. First, uniformity should help create a level playing field with respect to the entry of money services businesses (MSBs) into various states. Similarly, regulators should be able to share information and pool resources through the use of joint examinations and reporting. More generally, the uniformity of the reporting and record-keeping requirements should enable industry to comply with multiple state requirements in a uniform and cost-effective manner. Uniform licensing, reporting and enforcement provisions for MSBs should also serve as a more serious deterrent to money laundering than will a host of varying state laws.

Additionally, while many states have laws that deal with the sale of payment instruments, state regulation of money transmission, check cashers and currency exchangers is extremely varied. Furthermore, only a few states have attempted to create statutory frameworks that tie together the various types of MSBs in a way that assists regulators and attorneys general with respect to law enforcement and the prevention and detection of money laundering. The UMSBA creates a framework that connects all types of MSBs and clearly sets forth the relationship between a licensee and its delegates.

In some states, the Proposed Act will replace existing licensing laws for money transmitters and, potentially, check cashers. For the vast majority of states, the Proposed Act will provide new provisions for dealing with currency exchangers (which are virtually unregulated at the state level).

The Proposed Act provides a unique opportunity for states to take a consistent approach to the licensing and regulation of stored value and other forms of emerging Internet payment mechanisms. A uniform and consistent approach should provide less of a barrier to competition and growth in these new sectors. **For the majority of states, the Proposed Act will provide a new approach to the treatment of stored value and Internet payment services at the state level.** A handful of states have begun to license and regulate such diverse entities as nonbank stored-value issuers, Internet bill payment

services and Internet money transfer services. Rather than create a varied and complex regulatory system for these emerging payment service providers, the UMSBA attempts to provide a simple and consistent set of licensing requirements for these new entities.

The Proposed Act seeks to achieve several major goals:

- Placing all MSBs within a single legislative framework (keeping in mind the differences between various types of money services);
- Providing a strong uniform licensing law addressing safety and soundness that should give regulators an updated means of assessing whether a certain MSB should be permitted to engage in business within a state (and ensuring consistent standards across the country);
- Creating strong licensing mechanisms that should deter businesses that engage in money laundering and illegal activity from conducting business in a state;
- Strengthening enforcement and supervisory powers that should permit regulators and attorneys general to take appropriate action in the event of suspected money laundering or other related violations of law;
- Including new Internet-based money transmission services and the sale or issuance of stored value within a statutory framework to the extent appropriate in an effort to create a unified licensing mechanism that should not create a barrier to entry for new business entities;
- Providing industry with a cost-effective means of complying with various state licensing requirements; and
- Providing regulators with the means of reducing administrative costs through cooperation with other states and through the sharing and exchange of uniform information provided by licensees.

PARTICULAR SUBJECTS

The following subjects have been the focus of much of the Drafting Committee's efforts and are therefore deserving of your close attention. We believe we have gotten it as right as possible given the diverse interests of state regulators, industry and law enforcement with respect to the conduct and activities of money services businesses.

1. Scope of the Proposed Act and Creation of Separate Licensing Regimes

The UMSBA currently has two separate licensing regimes. The first is for money transmitters (consisting of money transmitters, payment instrument sellers, and certain types of Internet payment services). The second is for check cashers and currency exchangers.

a) Licensing

The UMSBA is a state safety and soundness law that creates licensing provisions for various types of MSBs. Licensing is potentially a crucial element in money laundering

prevention. Proper licensing mechanisms should help states to identify MSB operations that may be operated for illegitimate purposes and prevent them from conducting business in their states. Additionally, licensing is one method whereby states could monitor the operations of these businesses on an ongoing basis. Licensing should ensure better compliance with existing laws, especially if obligations are accompanied by appropriate enforcement mechanisms.

The Drafting Committee is aware of the potential implementation problems that may be created by licensing requirements. State banking departments have frequently been the administrative body vested with MSB oversight. The Drafting Committee has attempted to keep regulatory burdens to a minimum and focused on the types of provisions that would bolster the state regulatory and enforcement mechanisms.

To the extent that there is limited divergence in the requirements imposed by states with respect to issues such as the filing of renewal reports, the Proposed Act provides states with a consistent menu of options from which to choose. There are, however, potential benefits to be gained from a uniform statute. Uniform law would simplify MSB compliance efforts with respect to transacting business in multiple jurisdictions. The diverse nature of state law makes compliance difficult for some MSBs. The UMSBA would also facilitate and enhance enforcement of existing money laundering provisions.

b) Different requirements for various types of MSBs

Because the UMSBA is a state licensing statute which also has safety and soundness elements, the Drafting Committee has considered the extent to which all MSBs should (or should not) be subject to the same requirements with respect to safety and soundness of the business entries. Requirements related to capital adequacy, permissible investments, net worth and bonding are all tied to the safety and soundness of a business. The reason for the requirements is to prevent a business from becoming insolvent with customers having outstanding payment obligations (e.g., money orders that have not been redeemed).

The September 1998 Draft included a separate licensing regime for two distinct groups of MSBs. The first group was money transmitters, payment instrument sellers, and stored-value providers (these entities are still grouped together but are labeled more broadly as "money transmitters" for ease of definition). The second group was check cashers and currency exchangers.

The Drafting Committee concluded that check cashers and currency exchangers did not pose the same type of safety and soundness concerns for state regulators as other types of MSBs because they did not accept funds from consumers for obligations that might remain unpaid. Rather, both check cashers and currency exchangers immediately provide customers with funds as part of their services. Thus, there is no risk that customers may lose their money (as with the purchase of a money order that might not be redeemed on a future date). The Drafting Committee decided that check cashers and currency exchangers should be subject to different types of reporting and record-keeping requirements and should be exempt from bond requirements.

Check cashers and currency exchangers are still included within the Proposed Act (albeit in a different manner) because (1) there is some indication that the activity of

currency exchange itself (as contrasted to check cashing) is vulnerable to money laundering; and (2) the role of many check cashers and currency exchangers as authorized delegates of money transmitters means that they are potential vehicles for money laundering with respect to money transmission and the sale of money orders and traveler's checks.

In the current version of the Proposed Act, check cashers and currency exchangers are required to obtain a license ONLY IF they are not authorized delegates of money transmitters, payment instruments sellers, or stored-value providers. Committee members observed that check cashers and currency exchangers who act as authorized delegates would already be identified (for law enforcement purposes) as part of the information supplied to the state regulator by the principal licensee. Additionally, the UMSBA permits the state regulator to take enforcement actions against both licensees and authorized delegates. Check cashers and currency exchangers are subject to anti-money laundering provisions of the Proposed Act if they are either (1) authorized delegates or (2) licensed separately under the provisions for check cashers and currency exchangers.

c) Consumer Protection

The UMSBA also does not deal with issues such as consumer rate and fee regulation for check cashing. The mandate for this drafting project does not include review of consumer protection issues and therefore the Proposed Act addresses safety and soundness only as it relates to the prevention of money laundering rather than fee or rate regulation. Although the Drafting Committee was not directed to address consumer issues, the UMSBA nonetheless is not meant to replace or supplant existing consumer protection laws relating to check cashing. Instead, the UMSBA is meant to coexist with existing state consumer protection laws. Additionally, the licensing provisions for check cashing are separable to the extent that states have existing laws that combine licensing provisions with consumer protection provisions. As noted above, the UMSBA requires only those check cashers that are not authorized delegates to become licensed. Relatively few check cashers offer check cashing exclusively without offering an ancillary service of money transmission on behalf of a licensed money transmitter. Thus, the majority of check cashers will be authorized delegates under the UMSBA and subject to certain enforcement measures.

2. Treatment of Internet Payment Mechanisms

Subsequent to the first reading of the Proposed Act, the Drafting Committee focused on the treatment of new payment technologies within the framework of the UMSBA. The various types of payment mechanisms examined by the Drafting Committee are outlined below, followed by the decisions of the Committee within respect to their inclusion within the UMSBA.

The Proposed Act has been revised to incorporate certain Internet payment mechanisms into the existing licensing framework. However, the UMSBA does not include new or different licensing regimes for such payment mechanisms. The proposals contained in the UMSBA are not complex and cumbersome. Rather, they are simple and meant to apply the existing licensing frameworks to new technologies. Existing definitions have been expanded slightly to take into account the fact that (1) Internet payment mechanisms are in many respects the functional equivalent of traditional money transmission and (2)

that the sale of stored value is in many respects analogous to the sale of traditional payment instruments such as money orders.

The main changes to the Proposed Act involve an expansion of our traditional concept of "money." With the advent of the Internet and new microchip technology it is possible to exchange value that is not "money" in the traditional sense. The UMSBA consequently provides a new definition of "monetary value." Like money, monetary value can be transmitted. Similarly issuers need not sell a physical tangible payment instrument in order to issue value to consumers. It is possible for consumers to purchase redeemable value that may only exist in a computerized format. Hence, the UMSBA contains definition of stored value that is distinct from the traditional payment instrument. A more in-depth summary of the various types of Internet payment services that are encompassed within the definition of money transmission is included in the prefatory note to the Annual Meeting Draft of the UMSBA.

In March 2000, The Drafting Committee considered the recommendations of the Cyberpayments Working Group and decided to expand the scope of the UMSBA to include a broader category of payment mechanisms. In general, the Drafting Committee concluded that Internet-based payment mechanisms should be included within the scope of the UMSBA to the extent that such services involve the sale and issuance of monetary value or the transmission of monetary value by a nonbank, if the nonbank also holds a consumer's money for its own account prior to redemption. In such circumstances, **the Drafting Committee felt that the types of cyberpayment mechanisms listed above posed the same safety and soundness concerns as their brick and mortar counterparts.** In furtherance of this general principle, the Drafting Committee made the following decisions with respect to cyberpayments:

- **New concept of monetary value.** The definition of "money" and related definitions should be revised to reflect the fact that certain payment service providers employ a form of value that is not directly redeemable in money, but nevertheless (1) serves as a medium of exchange, and (2) places the customer at risk of the provider's insolvency while the medium is outstanding. The same safety and soundness issues pertinent to redeemable forms of value apply to these irredeemable forms of value. Online gift certificates (redeemable at many locations), reward points or precious metal transfers would constitute monetary value.

Based on this recommendation, a new definition of "monetary value" has been added. Monetary value is defined as "a medium of exchange, whether or not redeemable in money." The term "medium of exchange" connotes that value that is being exchanged be accepted by a community larger than the two parties to the exchange. Hence, bilateral units of account used in closed systems, such as university payment cards, would not constitute "monetary value" for purposes of this Proposed Act. A university payment card that was also accepted by a few local pizzerias could be at the borderline. A university payment card accepted by most local merchants in a city or town would likely be true open-system "monetary value."

- **Definition of stored value.** The definition of stored-value instrument should be changed to stored value because the instrument in which the stored value is embedded is not conceptually relevant. Any definition that conflates the two ideas may lead to confusion. For example, multiple issuers of stored value might provide different value on a

single instrument. The instrument is unitary, but the stored value is not. Alternatively, value might not be stored on any identifiable physical object, but stored instead by purely cryptanalytic means. Based on the change of term, the definition of payment instrument and the exclusion for certain stored-value providers has been amended as well.

In the Proposed Act, the term "stored value" is defined as "monetary value that is evidenced in an electronic record." The revised definition still excludes from regulation closed-end stored-value systems such as transportation cards and single issuer cards such as department store gift certificates. Because monetary value is defined as "a medium of exchange, whether or not redeemable in money," only stored value which consists of a medium of exchange evidenced in electronic record would qualify as stored value for purposes of regulation. **A medium of exchange needs to be something that is a widely accepted.** Closed systems, as mere bilateral units of account, therefore, would be excluded from regulation.

- **Definition of money transmission.** Internet payment services that hold customer's funds or monetary value for their own account rather than serving simply as clearing agents should fall within the scope of the Proposed Act. By contrast, entities that simply transfer money between parties as clearing agents should clearly fall outside the scope of a safety and soundness statute. The definition of money transmission should be revised to reflect this distinction.

The revised definition of money transmission has been amended as follows:
"Money transmission" means to engage in the business of:

- (a) selling or issuing payment instruments;
- (b) selling or issuing stored value; or
- (c) receiving money or monetary value for transmission to a location within or outside the United States.

The previous definition of "money transmission" included the "sale or issuance of a payment instrument, or engaging in receiving money for transmission, or transmitting money within the United States or to locations outside the United States". The revised definition omits the language "or transmitting money" in an attempt to distinguish between clearing services and entities that actually receive and hold funds or monetary value before transmitting it on behalf of a customer. The Drafting Committee decided that only those entities that received and held funds for consumers prior to transmission should be licensed under the UMSBA, whereas entities that merely served as clearing agencies and transmitted money but never were in possession of consumer funds (e.g., a credit card processing facility) should be exempt from licensing.

- **Exclusion of pure barter.** To the extent possible, the Proposed Act should not encompass entities that engage in pure barter activities but should encompass an issuer of monetary value that could be redeemed by multiple merchants for goods and services.

As noted above, the term "monetary value" is defined in such a manner as to exclude pure barter or activities where the "value" that is being exchanged is used for exchange with a single issuer or merchant or within a small geographic radius. Of course,

regulators will have discretion with respect to which entities are engaged in the transmission or issuance of monetary value. Some states, such as Texas, for example, require the issuer of mall gift certificates that can be redeemed at multiple issuers to become licensed.¹

- **Jurisdiction.** To the extent that Internet money transmitters choose to engage in money services online, they should be subject to regulatory jurisdiction if they meet the threshold for "engaging in business" with customers domiciled in a particular state.

3. Permissible Investments

State money transmitter statutes include lists of "permissible" investments. Money transmitters are required to maintain investments at all times that are equal to the market value of the aggregate face amount of all funds transmitted and outstanding payment instruments issued or sold by the money transmitter and all of its authorized delegates. Typically, permissible investments have included the following:

- cash;
- certificates of deposit of a financial institution (either domestic or foreign);
- banker's acceptances eligible for purchase by member banks of the Federal Reserve System;
- an investment bearing a rating of one of the highest grades as defined by a nationally recognized rating service of such securities;
- investment securities that are obligations of the United States, its agencies or instrumentalities, or obligations that are guaranteed fully as to principal and interest by the United States or any of its obligations of any state or municipality, or any political subdivision thereof;
- shares in a money market mutual fund;
- a demand borrowing agreement or agreements made to a corporation or a subsidiary of a corporation whose capital stock is listed on a national exchange; and
- receivables that are due to a money transmitter from its authorized delegates unless they are past due or doubtful of collection.

The Model Act Regulating Money Transmitters, the MTRA Model Legislation Outline and other state money transmitter statutes include lists similar to the one described above, with minor variations. There are no caps or restrictions on the amounts or percentage of overall permissible investments that a money transmitter can make in any one category. For example, it would be possible under many existing state statutes for a money transmitter to satisfy its permissible investment requirements solely through demand borrowing agreements with a parent or subsidiary corporation.

¹ Opinion 98-11 (February 19, 1998) of the Texas State Banking Commissioner (visited May 15, 2000) <<http://www.banking.state.tx.us/legal/opinions/98-11.htm>>.

The Drafting Committee expressed some concerns about the types of permissible investments that have been included in model legislation as well as in existing state money transmission statutes. As stated in the prefatory note, money transmitters have to maintain investments that are equal to the aggregate face amount of all their outstanding funds transfers and payment instrument obligations (on a dollar-for-dollar basis). The Drafting Committee observed that certain investments appeared more risky than others — especially in the absence of any limitations or caps on percentage of the licensee's portfolio invested in any of these items.

The Drafting Committee identified certain types of investments as higher risk:

- (1) shares in money market mutual funds, interest-bearing bills or notes or bonds, debentures on stock traded on any national securities exchange or on a national over-the-counter market, or mutual funds primarily composed of one or more investments of those items;
- (2) demand borrowing agreement made to a corporation or a subsidiary of a corporation whose capital stock is listed on a national exchange; and
- (3) receivables that are due to a licensee from its authorized delegate pursuant to a contract which are not past due or doubtful of collection.

The Committee thought that the lack of restrictions on the amount that a money transmitter could invest in any of the categories was problematic. Industry Observers pointed out that these types of permissible investments were typically contained in existing state law. The same Observers emphasized that it was important for many licensees to have diverse portfolios, which included the type of investments listed above.

With respect to the inclusion of receivables from delegates, industry representatives explained that the inclusion had become a necessity due to the use of automated money order dispensers. Typically, money orders are sold at sales outlets through automated dispensers. The automated dispenser immediately records the sale of the money order and notifies the money transmitter. This real-time "notification" immediately triggers the obligation of a money transmitter to retain permissible investments for the money order sold on a dollar-for-dollar basis. However, while the obligation to maintain investments is triggered at the time of sale, there is a lag of time until the sales outlet actually remits funds to the money transmitter. For the time period between sale and remittance of the funds that the sales outlet has received, the money transmitter needs to treat those "receivables" as part of its permissible investment portfolio. Previously, authorized delegates had notified a money transmitter of the number of money orders sold at the same time that it remitted a check for the funds received.

The current version of the UMSBA reflects an attempt to impose some restrictions on the type and amount of permissible investment that a money transmitter is allowed to make. The list of investments mirrors the list contained in earlier drafts. The main difference, however, is that the current provisions in the Proposed Act limit the aggregate amount of each of these contested categories of investments to 20 percent of the licensee's total permissible investments. Additionally, a licensee may not invest in more than 10 percent of any one entity whose investments fall into these categories. The revised section on permissible investments is an attempt to balance the concerns about the safety of the

investments made by licensees with the needs of MSBs to have diverse investment opportunities and to include receivables among the categories permitted.

4. Confidentiality

The issue of how to protect the proprietary information of licensees and license applicants has been an issue that has been the subject of much discussion during the Drafting Committee's deliberations. The current confidentiality provision, contained in Section 607 is meant to protect the business or proprietary financial information that may be submitted by a license applicant or licensee. The Drafting Committee, after hearing the views of industry representatives, concluded that it was important to provide licensees and license applicants with an appropriate degree of protection for various information, especially business and proprietary information, that is contained in applications and reports filed with state regulators. In the absence of such protections, information concerning an applicant's receivables, for example, could be used to reconstruct the market share of a particular MSB.