

## **Money Service Businesses - Meet Your Regulator(s)**

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Ubiquitous broadband, mobile computing technology, content galore, VC money everywhere ...let's develop a new payment system! Visa, MasterCard, American Express, Discover – so old school, stodgy, and card centric. Banks, not to mention PayPal, Amazon, Google and Yahoo, are looking for new payments models to differentiate themselves, so why not start up a new payments company and wait for a buyout? A couple of hundred thousand dollars for software and some marketing and you're on your way, right? Well, no. You have actually picked one of the most heavily regulated small businesses around.

Why is that? Well, think about your established competitors. They include banks and other financial institutions, and these are regulated. Now think about why that is. Well, one reason is that they handle other peoples' money (and presumably yours too), either by taking deposits, or selling payment instruments that substitute for cash to consumers. But, you say, the beauty of my business is that I do not take deposits, or sell payment instruments. I just provide a mechanism for consumers to move value from their existing accounts with banks or other regulated financial institutions. I am merely a financial intermediary, moving data. Surely that is not regulated activity? Yes, no and maybe.

Finding out whether you are required to be licensed as a money transmitter is going to cost you money, but the good news is that discovering this now has saved you lots of money and headache versus finding out about it later. More later about how much more start-up money you will need.

If you have followed the story of Pay Pal then you already know about the regulatory perils of the payments business. After years of assertion that their business model fell outside of regulation applicable to banks and money transmitters, they were forced to revise their business model to avoid charges of deposit-taking and to obtain licenses as a "money transmitter" in a large number of states. It was embarrassing for PayPal, since it all came to a head when they were about to do an IPO. Actually, the executives of PayPal should probably have been happy with simple embarrassment, since they could have ended up with an all-expenses-paid federal institution vacation.

It is fairly simple for start-up payment companies to avoid unlawful deposit-taking. Simply have a bank hold any funds received from consumers prior to the use of those funds to settle a payment transaction, if you can find a bank comfortable with doing so. Whether a bank will be comfortable doing so will depend on its comfort with your compliance with the other type of regulation you must contend with, the money transmitter laws. No bank wants to explain to its regulators why it is facilitating a non-compliant money transmitter business.

There are actually two distinct money transmitter regulatory schemes to consider, each with different purposes, but inter-related.

The first regulatory scheme that a payments business must comply with is the Bank Secrecy Act, as modified in 2001 by the Patriot Act. The Bank Secrecy Act before its modification was designed to ferret out money laundering, but the 2001 amendments gave it new teeth sharpened by the events of 9-11. Under the law, "Money Services Businesses" are subject to licensing and other requirements. Money transmitters are Money Services Businesses for purposes of the law and implementing regulations.

A Money Transmitter is defined as "Any person ... who engages as a business in accepting currency, or funds denominated in currency, and transmits the currency and funds, or the value of the currency and funds, by any means..." or "any other business engaged as a business in the transfer of funds". Although this is as all-encompassing a definition as one can imagine, there are some exceptions such as transmission of money to settle real estate or securities transactions where the transfer is incidental to a transaction for which the money is paying.

All Money Services Businesses are required to register with the Department of Treasury Financial Crime Enforcement Network ("FinCEN"), with certain exceptions. For instance, issuers, sellers or redeemers of

stored value are not required to register (although FinCEN is studying how to regulate those businesses, if at all). Agents of registered Money Services Businesses are not required to register unless they are conducting money services activities on their own behalf as well. Banks, credit unions and regulated broker-dealers are not required to register since they are already heavily-regulated by other agencies.

All Money Services Businesses are required to have effective anti-money -laundering programs in place (“AML Program”). The AML Program must be designed to address the risks of the particular business but must meet certain minimum requirements. These include policies, procedures and internal controls for customer identity verification, report filing and other compliance matters, education of personnel in the AML Program, a designated compliance officer, and provisions for third party review of compliance.

Customer identity verification must be based on the gathering and use of information about customers that reasonably verifies identity. Although the adoption of a Customer Identification Program like that required of banks is not necessary, a program that provides similar verification strength is required.

Every Money Services Business must report suspicious transactions over \$2000 (\$5000 in some cases), commonly referred to as a “SAR”, or suspicious activity report. Suspicious transactions are those where the intent appears to be to avoid or violate applicable law or to further illegal activity, e.g., money laundering.

Operating a Money Services Business without a license required under any state money transmission licensing scheme (these are described next) or registration with FinCEN is a felony, and this liability extends to any person who “knowingly conducts, controls, manages, supervises, directs, or owns all or part of the unlicensed money transmitting business”. As for ignorance of these requirements, remember Jeremy Bentham’s observation that lawyers are the only persons in whom ignorance of the law is not punished.

The second regulatory scheme a payments business must comply with consists of check seller or money transmitter licensing requirements in 45 states and the District of Columbia. Alaska, Hawaii, Montana, New Hampshire and South Carolina do not have money transmitter licensing laws, but that could change. State money transmitter licensing schemes have a consumer protection purpose, and the licensing requirements are designed accordingly to enable the regulator to vet the bona fides of the business and its owners and operators. Failure to register is typically a state criminal offense with fines and the possibility of imprisonment.

The fun with these state statutory and regulatory schemes is that they are not consistently structured or interpreted. This variability and ambiguity adds lots of complexity to any compliance program, particularly in the start-up phase. For instance, older statutes written before the advent of electronic financial transactions may specify licensing requirements only for sellers of checks (i.e. travelers checks, money orders), since those were the original “money transmitters”. Notwithstanding, regulators in those states may take an expansive view of the coverage of their laws to include the new forms of electronic money transmission. Seems wrong, or at least confusing, but it costs a lot of money to fight the government, so it is advisable to find out what the regulator thinks you should do and, unless you can persuade them otherwise, do it (unless you enjoy a good, long and expensive fight involving lots of lawyers – sounds good to me!).

Other state regulatory schemes are more recent and thus more modern and address directly electronic money transmission businesses. One group of these statutes prohibit receiving money from customers for money transmission purposes without a license, but say nothing about actual transmission of money itself. Another group of statutes prohibits both the receiving of money for transmission and the actual transmission of money without license. A third group of statutes prohibits transmission of money but make no explicit mention of electronic transmission. Some have argued that there are loopholes here that may be available to a money transmitter that seeks to avoid licensing in a particular state. For instance, in those states where the statute does not explicitly prohibit actual money transmission without a license but only receiving money for transmission, a business providing only financial intermediation services could argue it is not required to register. Unfortunately, this is a fine legal point that the regulators may or may not

agree with, again requiring time, money and lawyers to resolve (what a great business this can be for lawyers!).

Summing up, let me first point out, hopefully unnecessarily, that no decisions should be taken based on this brief description of money transmitter licensing and other requirements. You need to work with a lawyer experienced with these matters, and the sooner the better, since the way to minimize headache and expense is to work with the regulators early, but do so using counsel who know how to explain your business in terms the regulators appreciate. How much money should you budget for legal fees? If you want simply to obtain licenses in every state that thinks you should have one, without fighting their interpretation of their statute, perhaps \$100,000 will be sufficient. If you want to minimize the number of licenses you have to obtain, perhaps to minimize the yearly and ongoing compliance tasks that you will have to staff, then the cost can be \$300,000 or more. Just remember that ignoring these requirements is priceless.