

Legal Implications of Stored Value Cards (January 2005)

In the United States, gift cards and other stored value cards (SVCs) have become a hallmark in the modern retail economy. Consumers and retailers have widely embraced gift cards as a replacement to traditional gift certificates. Consumer familiarity and acceptance of gift cards and other prepaid services is increasing. Reusable cards such as the successful Starbucks Card have proven the effectiveness and convenience of prepaid instruments.

Companies seeking to issue their own cards in the United States must do so in compliance with many state and federal laws including laws on banking activity, money transmission, financial privacy, unclaimed property and anti-money laundering efforts. This article discusses the implications of these laws and their application to SVC systems generally.

Banking laws

In banking terms, the issuance of prepaid or other forms of SVC is considered a 'non-bank financial activity'. Federal and state banking laws generally are not applicable to prepaid services or similar SVCs unless the card issuer appears to be holding a demand or depository account for a third party.

The fundamental indicia suggesting a non-bank entity is acting as a bank (and therefore implicating the application of federal banking laws) is whether a non-bank issuer is in the business of receiving deposits or otherwise maintaining accounts as a debtor of its customers. In general, a 'deposit' typically contemplates the physical receipt and possession of money or its equivalent, payable upon the demand of the depositor. Moreover, at common law, a deposit is money placed in the custody and safekeeping of a bank, subject to withdrawal at the will of the depositor or pursuant to agreement. Federal and state laws either expand or narrow these basic attributes. Therefore, to avoid banking regulation, a non-bank entity must attempt to avoid being perceived as taking demand deposits or otherwise maintaining deposit accounts for consumers.

At the federal level, there has been significant activity regarding the regulation of SVCs, principally by the Federal Reserve Board. In 1996 the board considered amending Regulation E, enacted pursuant to the [Electronic Funds Transfer Act](#) (EFTA), to extend its consumer protection provisions to SVCs, namely notice requirements and limitation of liability for authorized use. In essence, the Federal Reserve Board considered SVCs to be an access device to an account within the meaning of the act. However, in response to a directive by Congress, prior to enacting any regulation, the board was directed to evaluate whether any regulatory alternatives existed that would satisfy EFTA's objectives. In 1997 the Federal Reserve Board acknowledged the substantial burdens EFTA would place on the nascent SVC industry and found that the existing legal framework provided sufficient incentives to SVC issuers to avoid unconscionable or unfair

terms and to make adequate disclosures. This conclusion and resulting forbearance from regulation set the existing federal policy on SVCs.

Although federal banking regulators have kept a hands-off approach, state law must be considered. Nearly all states have laws that address what constitutes the ‘business of banking’. This generally involves taking deposits and making loans – the former being the primary indicia. Most states have statutes that restrict such banking activities. State laws tend to focus on the debtor-creditor relationship created by taking a demand deposit. For instance, under New York law, a ‘deposit’ is the transfer of money to a bank to be withdrawn on the depositor's demand or under the rules and regulations agreed upon. Under California law, a ‘depositor’ is one who transfers money to a bank to the credit of the depositor and subject to the depositor's check thereby creating a debtor-creditor relationship. Any entity that solicits or receives deposits is engaging in the business of banking. Similarly, Texas law provides that the business of banking is the practice of exclusive depository institution functions of accepting deposits, discounting loans, paying checks and loaning money.

Federal and state banking laws generally have not been applied to prepaid services. However, as new types of electronic financial services emerge, they often do not fit neatly into legacy banking laws. Take for example Pay-Pal Inc. Pay-Pal permits individuals or businesses that do not have a banking relationship to accept payments using credit cards. Subscribers to its services may elect to have money paid to them for completed sales or they may elect to have funds held by Pay-Pal placed in a pooled account at a bank or savings institution or in a money market fund. Pay-Pal is licensed as a money transmitter in at least 17 states. Further, California, Idaho, Louisiana and New York banking authorities have reportedly questioned whether Pay-Pal is an unauthorised bank. In response to an opinion by Louisiana regulators that Pay-Pal's activities constitute the business of banking, Pay-Pal had to suspend services to and from Louisiana until issues were resolved with state regulators.

The activity at the state level contrasts with an opinion of the Federal Depository Insurance Corporation (FDIC). In response to a request by Pay-Pal, the FDIC found that money held by Pay-Pal on behalf of its subscribers was eligible for pass-through FDIC insurance. Based on Pay-Pal's representations, the FDIC determined in broad terms that Pay-Pal can act as an agent for the benefit of its subscribers and FDIC insurance can apply to each subscriber's deposits held in the pooled account(s). As a result of this opinion, Pay-Pal [notes](#) on its website that pass-through insurance may apply to subscribers' balances held in pooled accounts.

In making this determination, the FDIC briefly addressed the issue of whether Pay-Pal accepts deposits. In a circuitous [statement](#), the FDIC appeared to find that Pay-Pal does not take deposits:

"A fundamental requirement for funds to be considered 'deposits' under Section 3(l) is that they be 'received or held by a bank or savings association.' Inasmuch as [Pay-Pal] is a corporation and not a bank or savings association the result is self-evident. Moreover, we also note that [Pay-Pal] does not physically handle or

hold funds placed into the [Pay-Pal] service. Any further analysis is merely academic and we respectfully decline to engage in this exercise."

The FDIC also has given a series of other opinions and staff interpretations concerning stored value accounts involving payroll cards, pass-through insurance, and payment processors. In April 2004, the FDIC introduced a proposed rule to further articulate when an account associated with stored value cards or other forms of prepaid might constitute a deposit. The [proposed rule](#) would clarify the meaning of "deposit" as that term relates to funds at insured depository institutions underlying stored value cards. The proposed rule is significant because it is the first time since 1996 that the FDIC has addressed the issue of deposits and stored value card systems in a rulemaking.

The divergent regulatory treatment of Pay-Pal by state and federal authorities underlies the difficulties regulators have in applying traditional legacy laws to new and novel types of electronic payment systems. The various types of SVC will undoubtedly face similar regulatory ambiguity without changes in the law.

Money-service business laws

Even if an SVC system does not constitute banking, laws other than banking law are implicated at the state level. Specifically, states have ancillary authority to govern SVCs under their money-service business (MSB) laws, such as money transmission. These laws generally are not implicated by 'closed' SVC systems (i.e., systems in which the card is only redeemable in the goods or services of the issuer). However, such laws likely would apply if an SVC issuer were to act as an intermediary to facilitate payment on behalf of a third party (i.e., an 'open' system).

All but five states have some form of MSB statute,¹ usually in the form of a 'money transmitter' or 'sale of checks' statute. These laws are intended as consumer protection statutes and establish certain safety and soundness standards. Typically, a money transmitter or seller of checks is required to:

- obtain a licence from a state regulatory body (usually the regulatory agency that supervises banks);
- meet certain net worth requirements; and
- post a bond.

These statutes have a few common definitional themes (e.g., defining 'money transmission', 'payment instruments', 'checks' and 'money'). 'Money transmission' typically includes the transmission of money and the sale or issuance of payment instruments. 'Payment instruments' are defined broadly to include any instrument for the payment of money.

¹ States without laws include Alaska, Hawaii, Montana, New Hampshire, and South Carolina.

Of the 45 states that have MSB statutes, 23 have an express "goods and services" exception. This exception excludes payment instruments that are "redeemable by the issuer in goods and services." While the other 22 states do not have an express exception, they generally do not consider there to be any "transmission" of money or a "sale" of a check within the meaning of the law if the payment instrument is used in a completely closed system. Due to this exception (whether express or implied), gift certificates, merchant credits and closed prepaid systems generally are not regulated by state MSB laws.

However, state money transmitter laws are not uniform, creating a patchwork of compliance obligations for MSBs. One area of uncertainty is what constitutes a truly closed or 'quasi-closed' SVC system and whether quasi-closed systems should be subject to MSB laws and regulations.

As a result of the widely divergent MSB statutes, the [National Conference of Commissioners for Uniform State Laws](#) initiated a working group to draft a uniform law. This group was formed in response to the enactment of the [1994 Money Laundering Suppression Act](#) in which Congress recommended that the states pass uniform laws to license and regulate MSBs. States were directed to consider "businesses which provide check cashing, currency exchange or money transmitting or remittance services, or issue or redeem money orders, traveller's checks and other similar instruments." In consultation with state regulators, the commissioners formally introduced in August 2000 draft uniform money services legislation. The final [Uniform Money Services Act](#) (UMSA) was issued on August 27 2001 in substantially similar form.

The UMSA is broad in scope, addressing not only the money laundering concerns for which the UMSA was originally commissioned but also safety and soundness considerations associated with MSBs. The UMSA specifically includes stored value as a payment instrument subject to regulation. Importantly, it excludes closed SVC systems albeit by way of commentary. The commentary notes that to be regulated, stored value (in whatever form) must involve a medium of exchange. A medium of exchange needs to be widely accepted to be subject to regulation, so closed, bilateral systems would be excluded. The commentary also notes that university SVCs that include a few area merchants may not be regulated but if the SVCs were more widely accepted, they would be. Finally, Section 102(6) exempts from the scope of 'payment instruments' credit card vouchers, letters of credit and instruments that are redeemable by the issuer in goods and services. The intent is to exclude payment mechanisms that are already regulated by other laws, such as coupons and gift certificates.

Unfortunately, many commentators do not find much certainty in the commission's use of a 'medium of exchange' (an undefined term) as the demarcation point for the regulation of SVCs. It has inherent ambiguity and the commission's comments may not be a part of a state legislature's intent. The preference is to have a clear statement regarding the application of state law versions of the UMSA to SVCs.

The UMSA has not been widely adopted although the Council of State Governments has included the UMSA in its List of Suggested State Legislation. According to the commission, as of January 2005, Iowa, Vermont, Washington, and the US Virgin Islands have enacted it (or

some form of it) to date. The State of Washington adopted a substantially modified version in 2003 (HB 2661 and SB 6414) that expressly carves out closed SVC systems as well as certain types of quasi-closed systems (a first of its kind codification). Specifically, "stored value" is exempted from regulation. RCW § 19.230.020(12). Stored value is defined as "the recognition of value or credit to the account of persons, when that value or credit is primarily intended to be redeemed for a limited universe of goods, intangibles, services, or other items provided by the issuer of the stored value, its affiliates, or others involved in transactions functionally related to the goods, intangibles, services, or other items sold by the issuer or its affiliates." RCW § 19.230.010(26).

Financial privacy laws

The issuance of SVCs that are correlated to identifiable holders or subscribers directly implicates the requirements of the federal and state financial privacy laws – most importantly the [Gramm-Leach-Bliley Act](#), which:

- requires financial institutions to provide notice of their privacy practices to certain individuals;
- prohibits the disclosure of non-public personal information about those individuals to third parties without first providing the individual with an opportunity to opt out of such disclosures; and
- requires certain safeguards be implemented by financial institutions to protect such non-public personal information (e.g., the development of a written information security program).

The term ‘financial institution’ is defined very broadly to mean "any institution the business of which is engaging in financial activities as described in Section 4(k) of the Bank Holding Company Act of 1956." ‘Financial activities’ include not only a number of traditional financial activities specified in Section 4(k) itself, but also those activities that the Federal Reserve Board has found to be either closely related to banking or usual in connection with the transaction of banking or other financial operations abroad. According to the Federal Reserve Board, the ‘data processing’ category encompasses issuers of SVCs.

In addition, the [Financial Crimes Enforcement Network](#) (FinCEN) of the US Treasury Department has determined that the issuance, selling and redemption of stored-value products is a financial activity under the [Bank Secrecy Act](#). This act authorises the Secretary of the Treasury to issue regulations requiring financial institutions to keep records and file reports related to financial activities, principally to aid the US government in anti-money laundering efforts. FinCEN considers issuers, sellers and redeemers of stored value to be MSBs within the scope of the definition of ‘financial institutions’ under the Bank Secrecy Act.

Although the Federal Reserve Board and FinCEN have concluded that SVCs constitute a financial activity closely related to banking, the Federal Trade Commission’s [regulations](#) require

that an entity be "significantly engaged" in the financial activity in question for the Gramm-Leach-Bliley Act to apply. How this standard will be interpreted remains to be seen, but the regulations suggest that regularly providing a service involving a financial activity demonstrates that a business is significantly engaged in that activity.

Thus, the issuance and acceptance of SVCs likely qualify as a financial activity subject to the Gramm-Leach-Bliley Act unless the SVCs are issued on an anonymous basis. At this juncture, however, there is no clear guidance from the Federal Trade Commission or any other financial regulatory authority as to the application of the Act to SVC systems. The likelihood of regulation of an identifiable SVC system in the immediate future seems unlikely, at least until there is further dialogue at the regulatory level.

Anti-money laundering rules

In April 2002, FinCEN published interim final [regulations](#) implementing anti-money laundering provisions of the [USA PATRIOT Act](#) (the 'Interim Rule'). The PATRIOT Act made significant changes to the Bank Secrecy Act to provide additional tools to prevent, detect and prosecute international money laundering. A key requirement of the Interim Rule is the creation of a written anti-money laundering program. Such a program is to be tailored to the particular circumstances of the MSB's industry, commensurate with the risks posed by the size and location of the particular MSB and the nature and volume of the financial services it offers. Institutions subject to the rule were required to implement such a program by July 24, 2002 (or within 90 days of establishing a new business).

Under the Interim Rule, MSBs include sellers, issuers and redeemers of stored-value products. However, a stored-value company is not considered to be an MSB (and is therefore exempt from the rule) if it does not reach either of two financial activity thresholds: (i) the company does not sell stored value in an amount greater than \$1,000 in currency or in monetary or other instrument; or (ii) the company does not redeem stored value or other instruments for an amount greater than \$1,000 in currency or monetary or other instruments from any person on any day in one or more transactions.

Regulatory guidance at the time left open the possibility that SVCs that were only redeemable in the goods and services of the issuer (i.e., a closed system) are still within the scope of the definition since most cards are denominated in monetary value. However, in August 2003, FinCEN announced in a [ruling](#) that "FinCEN does not currently interpret the definition of stored value to include closed system products such as a mall-wide gift card program." This statement was given in response to an inquiry as to whether the issuance of a gift certificate or card that is redeemable only by participating retailers in a shopping mall constituted money transmission or stored value under the MSB regulations. FinCEN concluded that it did not and made the only definitive published statement concerning FinCEN's regulatory view on closed stored value systems. FinCEN did note that companies may also avoid anti-money laundering obligations by staying below both of the \$1,000 thresholds. FinCEN also currently exempts issuers, sellers and redeemers of stored value from suspicious-activity reporting and registration requirements.

For several years, FinCEN has been internally evaluating the issue of how to apply MSB laws to stored value instruments and to what extent. In the ruling, FinCEN stated that comprehensive rules addressed stored value were anticipated. However, none have yet been proposed due in part to the many different applications of stored value products.

Unclaimed property laws

Companies offering SVCs should closely consider how state unclaimed property statutes may affect their programs. State claims for unused funds may directly compete with a company's desire to recognise the revenue. Depending on how the program is structured, one or more states may have a claim for the funds of unused SVCs despite the use of expiration dates or dormancy charges.

The abandonment of so-called 'intangible' property, which includes SVCs as well as bank accounts, traveller's checks and gift certificates, raises unique issues. Unlike tangible property, intangible property is frequently in the possession of someone other than the owner (i.e., the holder). In the absence of legislation, holders of intangible property could assume *de facto* (if not *de jure*) title to intangible property by merely holding onto it for a sufficiently long period without communication with the owner.

To address state claims over unclaimed intangible property, the National Conference of Commissioners for Uniform State Laws promulgated the Uniform Disposition of Unclaimed Property Act in 1954 which was subsequently revised in 1981 and 1995 to become the [Uniform Unclaimed Property Act](#) (UUPA). Most states have adopted either the 1981 or 1995 version. The act abolished the common law on abandoned property and significantly changed the escheat notion for intangible personal property.

Intangible personal property that is abandoned and unclaimed does not escheat to the state nor is it available for anyone who can assert possession and control over it. Rather, after a dormancy period, the actual property or the proceeds from its sale are transferred to the state as the permanent custodian for the property's owner. Under the 1995 version of the UUPA the general dormancy period is five years, whereas under the 1981 version it is seven years. Since SVCs are essentially prepaid devices that represent monetary value (analogous to gift certificates or consumer credit balances), states require amounts associated with them to be remitted after the applicable dormancy period.

For companies that do business in more than one state, well-established jurisdiction rules have been enacted by the various states under the guidance of the US Supreme Court. The holder must pay the value of abandoned property to the state of the last known address of the apparent owner as shown on the records of the holder or otherwise. If the holder does not have a record of the apparent owner's address, then the holder must pay the state in which the holder is incorporated or domiciled. Thus, these jurisdictional rules create a disincentive for a holder to have specific knowledge about the apparent owner of an abandoned SVC, so that the holder may comply with the law of only one state.

Conclusion

SVCs will continue to penetrate the US and world markets due to their convenience, flexibility and financial benefits. However, any stored-value program will involve some regulation. The scope of regulation will vary with the program's goals. Important factors will include whether the system is closed or open, anonymous or identifiable, and high value or low value. As companies deploy their new stored-value products, they should be aware of the legal implications that accompany them.

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