



Selected U.S. Legal Issues in Issuance of Electronic Money

By John D. Muller
jmuller@brobeck.com

John Muller is Of Counsel with the law firm of Brobeck, Phleger & Harrison LLP in San Francisco. His practice focuses on bank mergers and acquisitions, new bank powers, electronic commerce, corporate governance and general regulatory advice.

For more information on Brobeck, Phleger & Harrison LLP, please see <http://www.brobeck.com>.

TWO PRELIMINARY POINTS

A. Electronic Money is Not Cash

Electronic money¹ functions as a medium of exchange, but it differs in two very important respects from "cash" (i.e., Federal Reserve notes and coins): it is not legal tender that must be accepted for the payment of debts, and it is an obligation of a private company rather than of the central bank. Many electronic money products are also, unlike cash, traceable to the payor. For a comprehensive overview of e-money issues, see:

gopher://gopher.cbo.gov:7100/11/reports/online
(Emerging Methods for Making Electronic Payments)
<http://www.occ.treas.gov/emoney/papinf.htm>

B. Money is Already Electronic

Large-value payments in the U.S. are already predominantly made by electronic payment systems, developed by banks and the Fed at significant expense and with well-established operating rules and legal frameworks. According to the National Automated Clearing House Association, in 1995 \$533 trillion was transferred by wire, \$11 trillion by Automated Clearing House and \$800 billion by credit card, compared to \$73 trillion by check and \$2.2 trillion in cash transactions. Electronic money is clearly attractive as a substitute for cash and checks, but it is unclear whether there are business reasons to develop new electronic money systems for large-value payments rather than adapting the existing systems to stored value card and Internet transactions.

LEGAL ISSUES

A. Can Non-banks Issue Electronic Money?

The concerns most commonly raised by those who question whether non-banks should be permitted to issue electronic money are:

- (1) non-banks, being less closely supervised, less familiar with developing secure payment systems, and perhaps

having less stake in protecting a valuable existing reputation, may be more likely to develop an e-money product that can be counterfeited or used more than once ("double spending");

(2) non-banks may have an unfair competitive advantage over banks because they are not subject to the costs of extensive government regulation and supervision; and

(3) because non-banks do not report to the central bank, non-bank issuance of e-money creates a greater threat that the central bank will be unable to track the money supply and will lose the ability to set monetary policy.

To date, the central banks in the U.S. and Europe have expressed different views on the seriousness of these concerns. The U.S. Treasury Department is chairing a group of representatives from the G-7 countries to coordinate policy approaches toward electronic money. See:

http://www.iitf.nist.gov/elecomm/glo_comm.htm

1. **United States** . The emerging Federal Reserve view is that the non-bank issuance of e-money should be permitted. The cost of developing and marketing e-money products provides a strong incentive for non-banks to develop secure products. Although non-banks may have some competitive advantages, banks have corresponding advantages in their existing payment systems and merchant relationships (many merchants are unlikely to accept e-money unless they can deposit it into their bank account, and banks can control which issuers' e-money they will accept). Banks also have well-established reputations; consumers are more likely to trust e-money issued by a major local bank than by a newly-formed non-bank.

The Fed doesn't expect e-money, whether issued by banks or nonbanks, to have a substantial impact on the Fed's ability to track the level of the money supply or to conduct monetary policy: if every person in the United States held \$150 of electronic money, which is not likely any time soon, the total amount of electronic money would be less than 10% of U.S. currency currently in circulation. If non-banks become significant issuers of e-money, the Fed will seek to establish a voluntary reporting system, similar to the system in place today under which non-bank issuers of travelers' checks report on the amount of travelers' checks in circulation (which is a component of the M1 monetary aggregate). The Fed will monitor developments closely to ensure that non-bank involvement in e-money issuance does not create unanticipated problems. See:

<http://www.bog.frb.fed.us/BOARDDOCS/SPEECHES/19960618.htm>

<http://www.ny.frb.org/pihome/news/speeches/sp961008.html>

2. **Europe** . The European Monetary Institute Working Group on EU Payment Systems in 1994 recommended that only credit institutions or companies supervised by the regulatory body which supervises credit institutions should be permitted to issue e-money. Recent speeches by German and Dutch central bank officials reiterate this conclusion. See:

http://www.systemics.com/docs/papers/EU_prepaid_cards.html

http://www.systemics.com/docs/papers/EU_perspective.html

<http://ourworld.compuserve.com/homepages/ckuner/meister.html>

3. **U.S. Banking Industry Efforts** . In 1995, the American Bankers Association Payments System Task Force issued a report concluding that only depository institutions should have direct access to the existing payment system (see <http://www.aba.com/payment.htm> for the executive summary of the Task Force report). This conclusion does not mean that non-banks could not issue electronic money, only that a non-bank issuer would have to use a bank or banks to settle transactions through the existing payment systems. The ABA has recently changed the Payments System Task Force into an ongoing Payments System Steering Committee.

The Bankers Roundtable has formed a Banking Industry Technology Secretariat (BITS) to address cyberbanking

issues. BITS has recently issued a Request for Information with respect to the potential design, development and implementation of real-time payment systems for electronic transactions. See:

<http://www.bankersround.org/public/phot.html>

B. Does the Receipt of Funds from a Consumer by an Electronic Money Issuer Create a "Deposit?"

1. **Non-banks** . For non-banks, the importance of the "deposit" issue arises not because of deposit insurance (non-banks are not eligible for FDIC deposit insurance²) but because deposit treatment would give federal and state regulators a legal "hook" to prevent non-banks from issuing electronic money if the regulators were so inclined. The Glass-Steagall Act provides that an entity may not engage "in the business of receiving deposits subject to ... repayment upon presentation of a pass book, certificate of deposit or other evidence of debt, or upon request of the depositor" unless the entity is incorporated in the U.S., permitted to engage in such business by the jurisdiction where the business is carried on, subject to examination by the banking authority of such jurisdiction, and publishes periodic reports of condition. 12 U.S.C. §378(a)(2). *U.S. v. Jenkins*, 943 F.2d 167 (2nd Cir. 1991), suggests that this statute is applicable only to individuals or entities that purport to be a bank or representatives of a bank.

Many states have comparable laws. California law: "no person which has not received a certificate ... authorizing it to engage in the banking business shall solicit or receive deposits, issue certificates of deposit with or without provision for interest, make payments on check, or transact business in the way or manner of a commercial bank or trust company." Cal. Financial Code §3390.

A conclusion that the funds a non-bank e-money issuer takes in from its customers in exchange for electronic value are "deposits" would also subject the non-bank to Federal Trade Commission ("FTC") jurisdiction. If the FTC determines that a non-bank is engaged in the business of receiving deposits and could reasonably be mistaken for a depository institution by the entity's customers, the non-bank may not use the mails or other forms of interstate commerce to receive or facilitate receiving deposits unless the non-bank's state supervisor has determined that the institution would be eligible for FDIC insurance if it were a bank. 12 U.S.C.A. §1831t(e).

In addition, if non-banks both accept "deposits" that can be withdrawn by check or similar means for payment to third parties and make commercial loans, they will be treated as banks for purposes of the Bank Holding Company Act, subjecting their parent companies to significant activities restrictions and Fed supervision. 12 U.S.C.A. §1841(c)(1).

The existence of these laws restricting non-bank acceptance of "deposits" has not kept non-banks from taking in consumer funds in return for transmitting money or issuing travelers' checks or money orders; federal and state regulators have viewed these activities as not involving any deposit. These activities, however, are regulated by the states (see Part E below). Similar state level regulation may be the price for non-banks that wish to issue electronic money.

2. **Banks** . For electronic money systems which limit the amount of value that can be stored to a fairly small amount (limits often mentioned for stored value cards are \$100 and \$300), deposit insurance is unlikely to offer any competitive advantage over non-insured products. In other words, consumers are likely to be more concerned about the security of the system, privacy of their information, and widespread acceptance by merchants than whether the bank holding their funds will remain solvent. Deposit insurance would carry the potential burden of deposit insurance premiums (currently zero for most banks). Nonetheless, if deposit insurance is a desirable feature, the FDIC has published a legal opinion by its General Counsel indicating how a stored value card system can be structured to meet the statutory definition of "deposit" and therefore be covered by federal deposit insurance. See:

<http://www.fdic.gov/consumer/svc/storedvc.html>

The FDIC General Counsel's opinion divides stored value cards into four separate categories: Bank Primary-

Customer Account Systems (funds remain in the customer's bank account until the electronic value is transferred to a merchant or other payee), Bank Primary-Reserve Systems (when value is downloaded onto the customer's card, funds are transferred from the customer's account to a reserve or general liability account held at the institution to pay merchants and other payees); Bank Secondary-Advance Systems (the issuer of the card is a third party, which provides electronic value to banks to make available to their customers; the customers then pay the third party for the stored value out of their bank accounts); and Bank Secondary-Pre-Acquisition Systems (the issuer of the card is a third party; banks pay the third party for the electronic value and subsequently resell that value to bank customers).

The opinion concludes that:

1. funds underlying Bank Primary-Customer Account Systems are "deposits" of the customer;
2. funds held by a bank in Bank Secondary-Advance Systems for the (presumably brief) period prior to their transfer to the issuer are "deposits" of the issuer; and
3. funds underlying the other two types of systems are not deposits under the statutory definition.

The opinion also states that the FDIC expects that institutions will clearly disclose to their customers the insured or non-insured status of their stored value products.

The FDIC also has regulatory authority to treat bank obligations relating to stored value cards and other electronic payment systems as deposits even if such obligations do not fall within the statutory definition of "deposit." The FDIC held public hearings on September 12 and 13, 1996 to take comments on deposit insurance issues related to electronic payment systems. See:

<http://www.fdic.gov/publish/valucard.html>

3. **Hybrid Institutions: Non-insured Banks.** U.S. federal banking law also creates the possibility that an institution can be both a bank and not insured by the FDIC. Such an institution must be authorized by state law. However, following the failure of Maryland and Ohio state deposit insurance funds in the 1980s, many states changed their laws to require that all banks be FDIC-insured. Therefore, it is not clear whether any state today would charter a non FDIC-insured bank to issue e-money.

If such an institution does come into being, it must receive written acknowledgement from its depositors that they understand the institution is not federally insured and, if it fails, the government will not guarantee the return of the depositors' money. The institution must also include the same disclosure in all of its advertisements and on every instrument evidencing a deposit. 12 U.S.C.A. §1831t(b).

C. For Banks, is Participation in the Issuance of Electronic Money a Permissible Banking Activity?

1. **National Banks** . The Office of the Comptroller of the Currency ("OCC"), rather than the Fed, has jurisdiction over the powers of national banks; the Fed's jurisdiction extends only to bank holding companies and their non-bank subsidiaries. The OCC has approved national bank participation in Mondex USA: "national banks may under 12 U.S.C. §24 (Seventh) engage in the business of developing and operating a stored value system". See:

<http://www.occ.treas.gov/interp/nov/conda220.htm>

According to the OCC approval, Mondex USA will operate through two limited liability companies ("LLCs"), which will be respectively the issuer of electronic value and the servicer of the Mondex USA system. The LLCs will be owned by a group of four national banks and three non-banks. See:

<http://www.mondexusa.com>

The OCC's approval is subject to several conditions, including:

- (a) the performance of services by the LLCs for national banks, including sale and redemption of stored value, will be subject to OCC regulation, supervision and examination;
- (b) the LLCs must stipulate that they are "institution affiliated parties" with respect to their national bank investors, giving the OCC enforcement jurisdiction; and
- (c) the LLCs must obtain OCC approval of any material changes to the LLC Operating Agreements.

2. **Bank Holding Companies** . The Federal Reserve Board has not yet squarely addressed whether the issuance of electronic money is sufficiently "closely related to banking" as to be a permissible activity for bank holding companies and their non-bank subsidiaries. However, related approvals indicate that the Fed is likely to find that the issuance of electronic money is a permissible activity. The Fed has authorized bank holding company-owned ATM networks to provide services for the operation of stored value card systems. **See *Banc One Corporation et al.***, 79 Fed. Res. Bull. 1158 (Dec. 1993) (MAC network); *The Bank of New York Company, Inc. et al.*, 80 Fed. Res. Bull. 1107 (Dec. 1994) (NYCE network). In addition, the Fed has determined that the issuance and sale of travelers' checks, money orders and similar consumer-type payment instruments, and the transmission of money both inside the U.S. and abroad, are closely related to banking. 62 Fed. Reg. 9338 (February 28, 1997) (to be codified at 12 C.F.R. §225.28(b)(13); 81 Fed. Res. Bull. 1130 (1995).
3. **Safety and Soundness Issues** . The OCC and FDIC have described the safety and soundness concerns they will expect banks to address before commencing operation of, or participation in, an electronic money payment system. See:

<http://www.occ.treas.gov/ftp/bulletin/96-48.txt>

<http://www.fdic.gov/elecbank.pdf>

The OCC Bulletin analyzes safety and soundness issues by identifying the various functions that banks may perform with respect to a stored value card system: investment in a company operating a stored value system, issuance of stored value, distribution of stored value cards for third party issuers, transaction authorization for systems that involve authorization prior to merchant acceptance, redemption of stored value held by merchants and consumers, clearing and settling, and transaction archiving. Banks must understand the different risks associated with each of these roles, as well as the need to ensure consumer understanding of the product.

The OCC suggests several specific items which banks should disclose to their stored value card customers: the identity of the issuer/obligor of the stored value, how to use the card, how and where the customer can load value on the card, whether the stored value earns interest or any kind of return, where it can be redeemed, any fees imposed on the customer, protection for lost or stolen cards, the availability of FDIC insurance, whether and under what circumstances information on transactions may be available to third parties, who is liable for transactions that are not completed properly, what happens to stored value that is not used for lengthy periods, and what dispute resolution mechanisms are available.

The FDIC examination procedures identify six specific areas of concern: planning and deployment (has senior management been involved in making decisions, and have cost and strategic implications been thoroughly considered), operating policies and procedures, auditability, legal risk (e.g., risk of unenforceability of electronic contracts, uncertainty regarding liability for errors, uncertainty regarding which jurisdictions may seek to regulate electronic transactions), administration and system operations (is the bank's security adequate? is the bank prepared to administer multiple standards and protocols?) and outsourcing (can the bank adequately monitor and control vendor performance?).

D. For Banks, Are Accounts that Hold Funds out of Which Electronic Money is Redeemed Subject to Reserve Requirements?

1. Non-banks are not subject to reserve requirements.
2. The bank accounts subject to reserve requirements are "transaction accounts" and "nonpersonal time deposits" (the reserve percentage for nonpersonal time deposits is currently zero).
3. The term "transaction account" is defined to include, among other items, any account (other than a savings deposit) from which the account holder may make third party payments at an ATM, remote service unit or other electronic device. 12 C.F.R. §204.2(e).
4. The definition of "savings deposit" creates opportunities for banks to structure accounts with third-party payment features that avoid reserve requirements. The definition includes accounts in which the bank reserves the right to require at least seven days' advance notice of withdrawals, and accounts from which the depositor can make up to six transfers and withdrawals (no more than three third-party payments) per statement cycle. 12 C.F.R. §204.2(d).

Numerous banks have also instituted arrangements which regularly sweep funds from a transaction account into a money market account that qualifies as a savings deposit. The Fed is "monitoring closely" the effect of such arrangements in lowering system-wide reserves and thereby influencing the implementation of monetary policy. 61 Fed. Reg. 69023 (Dec. 31, 1996).

The Fed, or at least some Fed staffers, are also beginning to consider a future in which monetary policy is conducted through means other than the manipulation of bank reserves maintained at the Fed. See

<http://www.frbkc.org/publicat/econrev/er96q4.htm#Sellon>.

E. For Non-bank Issuers, will States Attempt to Regulate Using Money Transmitter or Travelers' Check Statutes?

1. Almost all of the states require licensing of non-bank transmitters of money (e.g., Western Union) and issuers of travelers' checks. See, e.g., California Financial Code §§1800-1827, §§1853-1894.
2. Intentional operation of a money transmitting business without a license in a state where such a license is required is a federal crime. Money transmitting includes "transferring funds on behalf of the public by any and all means. . ." 18 U.S.C. §960. Section 407 of the Money Laundering Suppression Act of 1994 directs the Treasury Department to study the progress of the states in enacting a model statute for regulation of money transmitters, and report to the Congress by September 1997.
3. Money transmitter/traveler check statutes generally impose capitalization and reserve requirements much higher than bank requirements, designed to ensure that the issuer has sufficient funds on hand to make good on its commitments. If applicable to e-money issuers, these statutes may limit the use of funds received by the issuer in payment for the stored value and/or the ability of non-bank issuers to lend of electronic value.
4. Money transmitters, whether or not they are required to be licensed in the state(s) where they operate, are required to register with the Treasury Department. 31 U.S.C.A. §5330. Money transmitters and issuers of travelers' checks, money orders or similar instruments are subject to the Bank Secrecy Act and required to file reports on transactions of \$10,000 or more. *Id.* §§5311-5313.

F. Consumer Protection Issues

1. **Regulation E - Congressional Action . Regulation E, which implements the Electronic Fund Transfer Act ("EFTA"), includes restrictions on unsolicited issuance of access devices to consumers, and requirements relating to initial disclosures, advance notice of change in terms, transaction receipts and periodic statements, limitations on consumer liability and error resolution procedures. As a result of controversy over the Fed's proposal regarding the applicability of Regulation E to stored value card systems (see below), Congress has directed the Fed to study whether the Electronic Fund Transfer Act can be applied**

to stored value products without adversely impacting the cost, development and operation of such products, and whether alternatives to regulation could more efficiently achieve the objectives embodied in that Act. The Fed may not finalize any amendments to Regulation E that would regulate stored value products until the later of (a) three months after the study is submitted to Congress, or (b) June 30, 1997. Pub. L. 104-208, §2601, 110 Stat. 3009.

2. **Regulation E - Fed Proposal** . On May 2, 1996, the Fed published proposed revisions to Regulation E which would address stored-value card systems by classifying them as either:
- "on-line" (as with a debit card, transactions by a card holder to use the value associated with the card are authorized through communication with a central data facility, which debits an account held at the card issuer; balance information is not recorded on the card itself but only at the data facility);
 - "off-line accountable" (balances are recorded on the card itself and individual cardholder transactions are not required to be pre-authorized, but data on each transaction is stored and periodically transmitted to a central data facility, so that transactions are traceable to the particular card); or
 - "off-line unaccountable" (transactions are not pre-authorized, and are not traceable to a particular card; the record of the value remaining on the card is maintained only on the card itself).

Under the Fed's proposal, in all three systems, a transaction in which a stored-value card is "loaded" with value by accessing a consumer's deposit account will be subject to Regulation E and its transaction receipt and dispute resolution requirements. As to transactions in which the value on a card is used to make a payment, however, off-line unaccountable systems would be exempted completely from Regulation E, and off-line accountable and on-line systems would be exempted completely if the maximum value that can be stored is \$100 or less. If the maximum value is not limited to \$100, off-line accountable systems would be subject only to the Regulation E requirements on initial disclosures, while on-line systems would be subject to all requirements of Regulation E other than periodic statements (as long as an account balance and account history is available on request) and the requirement of advance notice of changes in terms.

The Fed proposal recognizes that banks and others are developing systems for computer network payment products that operate in a manner similar to stored value cards, i.e., a customer transfers value from the customer's bank account to the network payment product, and then uses that product to purchase goods or services. The Fed has not made any specific proposal, but requested comment on the extent to which the Board should address the applicability of Regulation E to network payment products. 61 Fed. Reg. 19696 (May 2, 1996).

3. Privacy

Privacy of information is shaping up as perhaps the major item for the widespread consumer acceptance of new electronic money systems. Principal areas to watch:

- (a) the battle between consumer/privacy advocates and retail/direct marketing groups over the conditions under which information about consumers and their transactions can be disclosed; and
- (b) the battle between privacy/commerce advocates and law enforcement over the widespread availability of strong cryptography and the ability to conduct transactions anonymously or pseudonymously. For (a), see:

<http://www.ftc.gov/bcp/online/pubs/privacy/privacy1.htm>

<http://www.ntia.doc.gov/ntiahome/privwhitepaper.html>

For (b), see:

<http://www.jya.com/crypto.htm>

<http://www.epic.org>

<http://www.treas.gov/treasury/bureaus/fincen>

4. Matching Consumer Expectations

With a number of competing e-money products available, likely the most important element in addressing consumer issues will be communicating clearly the features of the product, against the backdrop of consumers' knowledge of how existing payment systems work, and then ensuring that the product actually works as described. The key issues to be addressed, in addition to privacy, are (a) the identity of the obligor, (b) limits on consumer liability for unauthorized transactions (and on the corresponding payee side, the ability of merchants to obtain comfort that payments will not "bounce" and transactions cannot be repudiated), and (c) the effect of lost value (lost cards or unretrievable information on the consumer's hard drive). See:

http://www.house.gov/banking_democrats/consumers.html

<http://www.house.gov/castle/banking/brown3.htm>

<http://www.oecd.org/daf/ccp/cons/index.htm> (OECD Committee on Consumer Policy)

5. Advertising

As a corollary to #4 above, e-money issuers must take care to avoid inflated claims for their product. Are stored value cards and Internet payment products today as good as cash, given limited acceptance by merchants and limited ability to conduct anonymous transactions? The FDIC and Fed have already informally indicated that e-money issuers should not refer to their products as cash.

G. Commercial Law Issues

The issuance of electronic money will raise numerous commercial law issues of the type that are already settled for checks, Automated Clearing House transactions and wire transfers by the Uniform Commercial Code, Federal Reserve circulars and clearing house rules. Among such issues are when payments become final, liability for authorized payments completed improperly and the ability to pledge electronic value as collateral for a debt. The American Bar Association Section of Business Law has convened a Task Force whose report, *A Commercial Lawyer's Take on the Electronic Purse*, will be published in the February 1997 *Business Lawyer*.

Another important element in establishing the commercial viability of electronic commerce and electronic money is the development of rules of contract law and evidence regarding the validity of electronic contracts. In turn, the desire to establish methods for ensuring that electronic signatures are valid and cannot be repudiated creates a need in commerce for "trusted third parties" to verify the link between a person and his or her electronic signature. Because banks are already in the business of marketing their trustworthiness, banks are natural candidates to act as trusted third parties, e.g., as certificate authorities to tie a user to his/her public key in systems that use public key cryptography. For information regarding ongoing efforts to establish the validity of electronic contracts, state digital signature laws and the role of trusted third parties, see:

<http://www.abanet.org/buslaw/cyber>

<http://www.state.ma.us/itd/legal>

<http://www.law.miami.edu/~froomkin/welcome.html>

1. In this article, I will use the term "electronic money" to refer to both chip card-based and computer network-based stored value systems (systems which simply use the Internet to conduct credit card transactions do not raise the same legal issues). I will also use the term "bank" to include commercial banks, savings associations and any other FDIC-insured institutions.

2. Although funds held by non-banks are not insured by the FDIC, a non-bank e-money issuer can obtain deposit insurance for its customers by placing the funds on deposit at a bank. For example, the FDIC legal department, in an unpublished interpretation issued to Cybercash, has concluded that if a non-bank issuer were to accumulate the funds it receives from its customers and place those funds into a bank account, that account would be eligible for pass-through deposit insurance (up to \$100,000 per customer).