Held Hostage

How the Banking Sector Has Distorted Financial Regulation and Destroyed Technological Progress

Aaron Greenspan

Think Computer Corporation
August 15, 2011

Think

Abstract

In 2008, a global financial crisis second only to the Great Depression shed light on the utterly dysfunctional system of financial regulation governing the United States. A cacophony of laws and agencies, charged with regulating retail and investment banks, ultimately failed to prevent (and ultimately accelerated) an epic economic disaster that required enormous taxpayer bailouts of private enterprise, sunk two investment banks (Lehman Brothers and Bear Stearns), imploded an enormous insurance provider (A.I.G.), leveled the American auto industry (General Motors and Chrysler), and destroyed the student loan and mortgage industries, among many, many others. Drafted quickly amidst the wreckage, the Dodd-Frank Financial Reform Act was supposed to solve many of the problems that had led to the crisis. Today, the reality is that it has solved almost nothing, while introducing significant new problems.

Three years later, business is conducted in the same exact way that it was in 2008. It is more important than ever for consumers to have alternatives to financial products and services offered by the very same banks that only a few years ago brought the global economy to its knees, but such alternatives barely exist. In forty-six states and Washington, D.C., offering stored value and money transmission services is illegal without licenses that are virtually impossible for a single new company to obtain.

Money transmission laws that differ from state to state have completely escaped the notice of policy makers in Washington, but they are the single most important bottleneck preventing positive change from taking hold in America's financial system. With the nation facing yet another recession and already-high unemployment, such change is urgently needed.

This paper examines the present state of money transmission regulation in the United States and the ramifications thereof.

The Problem

With consumer confidence at its lowest levels since 1980,[1] the American consumer is not doing well. There are enormous challenges associated with our current era of unparalleled inequality, in which the middle class is quickly disappearing. When it comes to financial products and services, such as checking and savings accounts, loans, mortgages, and pre-paid plastic cards, it is fair to say that the average consumer is being regularly hammered. Each product and service seems to come with unexpected fees, reams of fine print containing misleading terms and conditions, and the kind of customer service that really requires a redefining the word "service" to mean something akin to "abuse" in order to square the moniker with reality.

Small businesses are not doing particularly well, either. Many feel the need to accept plastic payment cards issued by Visa, MasterCard, American Express and Discover in order to satisfy their customers, some of whom earn valuable financial rewards for using their cards. Acceptance comes with a price, however. It's hard to say exactly how much that price is, since the fee guides—that is, it actually requires a guide to navigate through so many fees—issued by each card company are typically well in excess of one hundred pages long. Generally, plastic card acceptance involves a fixed per-swipe authorization fee (regardless of whether the card is accepted or declined) of approximately $0.25; a base discount rate of roughly 2.5% (or sometimes higher than 4.0% for American Express); discount rate surcharges for rewards cards, international cards, and specific industries; a monthly fee; a gateway fee; a fixed setup fee, and occasionally a terminal rental fee. Some companies have business loans that are actually tied to their credit card processing agreements; as long as the loan is outstanding, the business is contractually required to encourage customers to pay with a plastic card in order to keep the fees rolling in. This has the intended side-effect of making it harder to pay back the loan.

With these sub-optimal conditions for consumers and small businesses alike, it would make sense for the market to eventually devise a more reasonable alternative that does not actively exploit the consumers and businesses that the system is supposed to serve. Yet in the sixty years that have elapsed since the current plastic-based infrastructure was devised, none has surfaced. It's worth asking why.

The History of Money Transmission Law

Money transmission, as it is typically thought of today, almost exclusively involves electronic finan-

1 *See* Retail Sales Rise, but Pessimism Drives Consumer Sentiment to a 30-Year Low *by Reuters, http://www.nytimes.com/2011/08/13/business/economy/retail-sales-rise-but-consumer-sentiment-hits-30-year-low.html.*

cial transactions, but this is a relatively recent phenomenon. Throughout the early part of the twentieth century, with only a few (if any) computers scattered throughout the world, travelers checks and money orders dramatically increased in popularity. Though a few states passed laws designed to regulate these forms of payment as early as the 1950s—Delaware passed its Sale of Checks and Transmission of Money Act in 1953—many more passed money transmission laws in the following decade.

Inherent in the process of sending a money order or cashier's check is the step of the sender first giving funds to the intermediary business, usually not an FDIC-insured bank, which then might or might not carry through with its obligation to forward the funds along to the intended recipient. It was only a matter of time before one such intermediary business failed to make good on its promise, and so on January 16, 1964, when a Los Angeles-based currency exchange firm went bankrupt, an enormous amount of systemic risk was exposed, to the tune of $1 million (about $7 million in 2011 dollars). The firm's failure made headlines both in California and across the nation, and it apparently caught the attention of numerous state legislators.

In 1965 alone, Pennsylvania passed its money transmission law, Georgia passed its Sale of Checks Act, Nebraska passed its Sale of Checks and Funds Transmission Act, Oklahoma introduced its Banking Code, and Arkansas passed its Sale of Checks Law. All of these laws explicitly forbade the sale of checks without a license, and if they did not also explicitly forbid the operation of a money transmission business as well, then they were later amended to correct the omission. Other states followed along after some delay, with Nevada passing its law in 1977.

On August 1, 1986, Northwest Financial Express, Inc. (NWFX), an Arkansas corporation, filed for voluntary bankruptcy under chapter 11. NWFX sold money orders through grocery stores in several states, including Texas. Soon after, one Houston grocery chain, Pyburn Enterprises, Inc., found itself in litigation with NWFX. In its ruling[2], the United States Court of Appeals, Eighth Circuit stated, "NWFX's bankruptcy had a devastating effect on thousands of Texas citizens who purchased NWFX money orders. Most of the money orders were purchased by people with low incomes. The money orders were often purchased to pay bills such as rent and utility expenses. Accordingly, when NWFX money orders were dishonored money order purchasers faced dire consequences." On August 15, the *Dallas Morning News* ran an article with the headline "New Money-Order Regulations Sought," stating, "State Rep. Al Granoff, D-Dallas, on Thursday filed a bill calling for the Texas Legislature to impose more stringent regulations on companies selling money orders in Texas

---

2 *See* 881 F.2d 530, *http://ftp.resource.org/courts.gov/c/F2/881/881.F2d.530.88-2395.html.*

following the state's largest money order failure earlier this month."

In 1995, money transmission laws came into focus once again. As part of a comprehensive series of legislative recommendations, the National Alliance for Model State Drug Laws (NAMSDL), a non-profit organization funded by Congress as the successor to the President's Commission on Model State Drug Laws, published its template for money transmission legislation. Concerned that drug-related funds were being laundered through unmonitored money transmission businesses at a rate of billions of dollars per year, the NAMSDL modeled its template on Arizona's 1991 money transmission statute, and recommended that other states follow suit with strict penalties for non-compliance. Several did, with Tennessee passing money transmission legislation in 1996 and Maine passing its law in 1997.

In the summer of 2001, recognizing the wide disparity in regulations from state to state, the National Conference of Commissioners on Uniform State Laws completed its work on the Uniform Money Services Act (UMSA).[3] The UMSA was "approved and recommended for enactment in all the states," but only a select few states, such as Alaska, Arkansas, Iowa and Washington, actually adopted it, some taking many years to do so. (Since the UMSA was proposed, two of its eight authors have passed away, perhaps leaving fewer people to advocate for its benefits.)

Just as the ink on the UMSA was drying, the events of September 11, 2001 once again cast a decidedly harsh light on the money transmission industry when activities of *Al Qaeda* terrorists were linked to the *hawala* informal money transfer system frequently used in Islamic nations, such as Saudi Arabia and Somalia. Many government officials feared that despite its predominantly legitimate use dating back centuries, *hawala* could be used to finance another terrorist attack.[4] Consequently, when the USA PATRIOT Act was passed in 2002, it enhanced 18 U.S.C. § 1960 with severe criminal penalties for operating an unlicensed money transmission business in violation of any state law, effectively turning what had previously been a state enforcement action into a federal crime.

By 2004, Hawaii still did not regulate money transmission and faced the question of whether or not it should. In October of that year, the Auditor of the State of Hawaii prepared a report for the Governor and Legislature in response to Hawaii's House Bill 2428[5] in which it stated that it had found "little evidence of harm to consumers or to the public," that "the proposed regulation provides

3 *See http://www.law.upenn.edu/bll/archives/ulc/moneyserv/UMSA2001final.pdf.*

4 *See* The hawala alternative remittance system and its role in money laundering*, http://www.interpol.int/Public/Financial-Crime/MoneyLaundering/hawala/.*

5 *See* Sunrise Analysis: Money Transmitters*, http://www.state.hi.us/auditor/Reports/2004/04-10.pdf.*

few added benefits to consumers while costs to taxpayers and consumers are uncertain," and finally recommending that "regulation of money transmitters is not warranted." Hawaii passed the bill into law anyway, and it became effective in 2007.

Most recently in 2010 (effective January 1, 2011), with its Money Transmission Act, California consolidated three financial laws into one and added for the first time statutory requirements for domestic money transmitters, as it had previously only regulated international money transfers.[6] Not long after, in May, 2011, New York passed legislation requiring all money transmitters doing business in the state to obtain licenses, whereas it had previously only regulated businesses with a physical presence in New York.[7]

Money Transmitters Versus Banks

Banks and money transmitters differ in several crucial ways. The most important distinction is that money transmitters do not make loans. This one difference drastically changes the risk profile for money transmitters relative to banks. While a run on a bank could mean that consumers are left empty-handed, since much of a given bank's deposits have been loaned out on any given day, a similar run on a money transmitter offering a stored value product would not be a cause for alarm. Unlike banks, money transmitters offering stored value have at minimum of one dollar in cash available for every dollar in deposits.

Another key difference between money transmitters and banks is the way in which each institution is able to take advantage of new technology. Over the years, with certain exceptions for the largest banks in the country, banks have largely outsourced their information technology departments to roughly five systems integrators, with Fidelity National Information Services, Inc. and Fiserv, Inc. responsible for most small banks' technology infrastructure. Unless one of these companies decides to offer a new product or service in their software, banks have little to no ability to customize their offerings. This model of heavy dependence on a few companies that maintain legacy systems means that the industry barely ever changes. Aside from that, it seldom wants change. According to Fiserv, most financial institutions view themselves not as leaders, but "fast followers."[8]

---

6 *See ftp://leginfo.public.ca.gov/pub/09-10/bill/asm/ab_2751-2800/ab_2789_cfa_20100628_154447_sen_comm.html.*

7 *See* S5209-2011: Relates to retail instalment contracts and transmitters of money, *http://open.nysenate.gov/legislation/bill/S5209-2011.*

8 *See* Acceleration in the Mobile Banking and Payments Landscape: Insights and Perspectives from Financial Institutions, *http://www.fiserv.com/WP_2011-mobile-payments-white-paper-v1.pdf*

Meanwhile, with millions of mobile phones being sold each year across the world, it is clear that the banks are being left behind by the pace of technological change. Given the difficulty of obtaining a charter to start a bank, money transmitters are in the best position to take advantage of new technological developments in the financial services space, as they are completely unhindered by dependence on the systems integrators mentioned above. One aspect of technological change that banks have been either unable or extremely reluctant to take advantage of is the ability to provide greater transparency to consumers about the status of their accounts in real time. For example, while mobile devices are capable of displaying a checking account balance to a consumer at the point of sale, plastic cards are not. This ability alone might reduce the number of Not Sufficient Funds fees assessed by banks by millions of dollars per year.

On the other hand, money transmitters lack Federal Deposit Insurance Corporation (FDIC) coverage,[9] making them more risky for consumers as primary stores of funds than banks. Banks are aware of this, and have recently begun charging their customers a premium for the security of their deposits. Minimum balance fees, which for years were rare for many consumers, have come back with a vengeance since the implementation of the Dodd-Frank Financial Reform Act. Free checking accounts are disappearing, as well as debit card rewards programs, which are mostly gone already. Most banks do not permit depositors to maintain a bank account with a zero-dollar balance for more than 30 days, and banks will frequently close such accounts without notice, cutting off the customer's access to records indicating prior balances. In contrast, money transmitters routinely allow customers to maintain accounts with zero-dollar balances, and generally do not charge minimum balance fees.

The Impact of Existing Regulations

While each state's money transmission statutes are different, the web site of the National Conference of Commissioners on Uniform State Laws does an excellent job of summarizing what money transmission legislation is actually designed to do.[10]

> Broadly speaking, the Uniform Money Services Act...provides that a person may not engage in specific regulated activities (money transmission, check cashing, and currency exchange) unless they hold a qualifying license or are an authorized delegate of a person

---

9 *Money transmitters can qualify for FDIC pass-through insurance, but this only protects depositors if the bank holding the money transmitter's pooled funds defaults, not if the money transmitter itself defaults. No federal insurance mechanism protecting consumers' deposits with non-bank entities presently exists.*

10 *See http://uniformlaws.org/ActSummary.aspx?title=Money%20Services%20Act.*

holding a qualifying license. Licensing is set up as a three-tiered structure -- if a person is licensed to engage in money transfer services, he or she can also engage in check cashing and currency exchange without having to obtain a separate license for that purpose; if a person is licensed to engage in check cashing, he or she can also engage in currency exchange (but not money transfers); if a person is licensed to engage in currency exchange, he or she may only engage in currency exchange services.

In the case of money transmission services, the act specifies the disclosures that must be made in an application for licensure, including information about the licensee (criminal convictions, prior related business history and operations in other states, and material litigation), information about proposed authorized delegates, sample payment instruments, banking information, and any other information reasonably required by the state regulator. Corporate and publicly traded entities are each subject to special, additional disclosures, and state regulators retain the express power to waive, or add to, the disclosure requirements under the act. Money transfer applicants must satisfy certain security requirements (typically by providing bonds in specified amounts), must meet threshold net worth requirements, and are required to pay statutorily-defined license fees. While the act suggests particular amounts for these purposes, enacting states may substitute fees and security requirements appropriate for each jurisdiction. Applicants must also retain security thresholds for 5 years past the date of transaction, and are subject to regular licensure review and renewal (with additional disclosures and fees).

It is important to note that the vast majority of legislation drafted to regulate money transmission on the state level has been reactive, not proactive. Each time another money services calamity has afflicted the nation, the response of legislators has been to crack down accordingly. In contrast, at the federal level, efforts to regulate what the Department of the Treasury refers to as Money Services Businesses (MSBs), though not by any means perfect, have proven to be more thoughtful. The Treasury's primary concern has been the prevention of financial fraud, and so all MSBs are required to register every two years with the Financial Crimes Enforcement Network (FinCEN). Much of the Treasury's authority in this regard stems from the Bank Secrecy Act of 1970 (BSA), which was amended by the USA PATRIOT Act in 2002.

As of year-end 2011, only a few states remain that do not specifically regulate money transmission: Massachusetts, Montana, New Mexico, and South Carolina. Though not a state, Washington, D.C. does regulate money transmission.

Table 1: State money transmission license requirements

State / District	Net Worth Minimum	Surety Bond Minimum	Surety Bond Maximum	Application Fee	License Fee
Alabama	5,000.00	10,000.00	50,000.00	250.00	250.00
Alaska	25,000.00	25,000.00	125,000.00		500.00
Arizona	100,000.00	25,000.00	500,000.00		1,500.00
Arkansas	250,000.00	50,000.00	250,000.00	1,500.00	750.00
California	500,000.00	750,000.00	9,000,000.00		5,000.00
Colorado	250,000.00	1,000,000.00	2,000,000.00	3,750.00	3,750.00
Connecticut	500,000.00	40,000.00			1,875.00
Delaware	100,000.00	10,000.00	2,000,000.00	172.50	0.00
District of Columbia	100,000.00	50,000.00	500,000.00		500.00
Florida	100,000.00		250,000.00		
Georgia		50,000.00	250,000.00	250.00	2,000.00
Hawaii	1,000.00	1,000.00	500,000.00	2,000.00	2,000.00
Idaho	50,000.00	50,000.00			100.00
Illinois		100,000.00	2,000,000.00		100.00
Indiana	100,000.00	200,000.00	300,000.00		
Iowa	100,000.00	50,000.00	300,000.00		1,500.00
Kansas	250,000.00	200,000.00	500,000.00		100.00
Kentucky	500,000.00	500,000.00	5,000,000.00		500.00
Louisiana	100,000.00	25,000.00	1,000,000.00		370.25
Maine	100,000.00	100,000.00			500.00
Maryland		150,000.00	1,000,000.00		4,000.00
Massachusetts	None	None	None	None	None
Michigan	100,000.00	500,000.00	1,500,000.00		
Minnesota	25,000.00	25,000.00	250,000.00		4,150.00
Mississippi	25,000.00	25,000.00	500,000.00	50.00	750.00
Missouri		100,000.00	1,000,000.00		100.00
Montana	None	None	None	None	None
Nebraska	50,000.00	100,000.00	250,000.00		1,000.00
Nevada	100,000.00	10,000.00	250,000.00		675.00
New Hampshire	Lesser of ADTL or 1000000	100,000.00			500.00
New Jersey	100,000.00	100,000.00			
New Mexico	None	None	None	None	None
New York		500,000.00			
North Carolina	100,000.00	150,000.00			1,500.00
North Dakota	100,000.00	150,000.00			850.00
Ohio	25,000.00	300,000.00			6,000.00
Oklahoma	275,000.00	50,000.00	1,000,000.00	3,000.00	2,000.00
Oregon	100,000.00	25,000.00	150,000.00	1,000.00	1,000.00
Pennsylvania	500,000.00	1,000,000.00			2,000.00
Rhode Island	50,000.00	50,000.00	150,000.00		360.00
South Carolina	None	None	None	None	None

State / District (Continued)	Net Worth Minimum	Surety Bond Minimum	Surety Bond Maximum	Application Fee	License Fee
South Dakota	100,000.00	100,000.00		500.00	1,000.00
Tennessee	100,000.00	50,000.00			500.00
Texas	500,000.00	300,000.00		2,500.00	
Utah	1,000,000.00	50,000.00		100.00	
Vermont	100,000.00	100,000.00	2,000,000.00	1,000.00	500.00
Virginia	200,000.00	25,000.00	500,000.00	1,000.00	1,000.00
Washington	10,000.00	10,000.00	550,000.00	500.00	500.00
West Virginia	50,000.00	300,000.00	1,000,000.00	1,000.00	250.00
Wisconsin		300,000.00	300,000.00	300.00	500.00
Wyoming	25,000.00	10,000.00	500,000.00	1,500.00	
TOTAL		**7,816,000.00**	**35,425,000.00**	**20,372.50**	**50,430.25**

Nationwide licensing is extremely expensive. A new money transmitter hoping to operate across the country faces annual surety bond premiums of approximately $225,000 dollars per year (assuming a 3.00% premium rate, which requires extremely good credit). Application fees alone cost $70,000, not including renewal fees, which are approximately equivalent to initial license fees in most states. Some states require a net worth of at least $1,000,000 dollars. Others, such as Hawaii, require a net worth of $1,000, but charge $4,000 in fees.

Despite the enormity of the fees, the tools available to money transmitters to combat fraud are in a word, pathetic, suggesting that the fees are not even being used to further the nominal goal of consumer protection. Though it is never stated, the FinCEN BSA reporting web site[11] is incompatible with every web browser except for Microsoft Internet Explorer, which computer security experts widely regard as the least secure web browser available. Even then, it requires the use of unwieldy plug-ins to handle even the most basic of functions. The system cannot handle more than a few lines of text to describe complex money laundering schemes. Another tool that all money transmitters should use is the Social Security Death Master File, a list of every Social Security Number known to be assigned to a deceased individual. Obviously, these numbers should be considered invalid when presented on new applications for financial products, yet access to the Master File costs several thousand dollars in a typical use case.[12] The Master File should be free to all companies registered with FinCEN. In fact, integration with an Application Programming Interface that relies upon the Master File should be mandatory for federal licensure. Similarly, state Departments of Motor Vehicles should work with FinCEN to open a standard API for vehicle registration information to money transmitters, who frequently check photo IDs, but rarely know if the IDs they are checking

11 *See https://bsaefiling1.fincen.treas.gov.*

12 *See http://www.ntis.gov/products/ssa-online.aspx.*

are valid.

In this context, a new technology startup wishing to enter the market to compete with Visa, MasterCard, American Express and Discover faces the prospect of completing and then affording applications for forty-seven separate state licenses, and then building its own tools to combat fraud since the government makes its tools unaffordable. Not obtaining all of the licenses, but operating a nationwide money transmission business anyway, is a federal crime punishable by five years in prison under 18 U.S.C. § 1960. Of course, licensed or not, failure to detect fraud can bankrupt a company.

The typical process of applying for a license in a single state takes anywhere from weeks to months. Information needs to be gathered from a variety of disparate sources. States typically want to see proof that the applicant has registered with FinCEN at the Department of the Treasury; evidence that the company's officers, major shareholders and/or directors are fiscally sound as individuals, which usually means that a personal financial statement needs to be ready for each person; enough information to conduct a criminal background check on each individual, meaning that fingerprints need to be provided on specific custom police cards for each state (not all states accept digital fingerprints, though the facilities to transmit them are widely available); audited financial statements for three years prior to the application date indicating that the applicant meets whatever net worth threshold the state has set; a business plan; pro-forma financial figures (which typically amount to wild guesses as no one can predict the future); proof of an Anti-Money Laundering program that complies with the directives of the BSA; a surety bond or substitute security device underwritten for the amount required by the given statute; a Certificate of Good Standing from the state in which the applicant is incorporated; and depending upon the state, proof that the applicant has registered with the Secretary of State of the particular state in which the applicant intends to do business.

The requirement of audited financial statements is particularly problematic, not just in the context of money transmission, but in general.[13] Auditors are less concerned with providing accurate financial information than they are with pleasing their clients (who pay for the audits) and earning fees, sometimes as high as $40,000 per fiscal year included in the audit. A state's requirement for three years of audited financials could therefore easily give an auditor a $120,000 incentive to get the job done—more than enough to incentivize even an experienced accountant to gloss over important details.

---

13 *See* Andersen, Meet Aetna: What's the best way to prevent future accounting scandals? Audit insurance. *by Daniel Gross. http://www.slate.com/id/2073848/pagenum/all/.*

Some states have put so little effort into their maintaining their application processes that they appear insulting to those trying to wade through them. No two state's application forms are the same, even in cases where the states have adopted the UMSA. The State of Colorado's application form requests that the applicant submit twelve additional copies of the application along with applicable fees, and yet the hyperlink to the fee schedule is broken. Thus far, no state has implemented a web-based application process, which suggests that regulators are unable to keep up with the increasingly technology-intensive companies that they are supposed to be regulating.

Other states have been underfunded to the point where exams of applicants are not even conducted, making the entire process moot. Hawaii's Department of Commerce and Consumer Affairs reported to the legislature in October, 2008 repeatedly indicating, "there was inadequate funding available to actually implement the supervisory and regulatory provisions of Act 153 – The Money Transmitter Act. There have been, therefore, no money transmitters examined by the Department of Commerce and Consumer Affairs thus far."[14] Indiana has money transmission statutes that appear to apply to all businesses in the state, but it does not enforce them for companies without a physical presence in Indiana. Wisconsin is inexplicably in a similar position: it has clear statutes, but none of the major internet-based payment companies are licensed there. Maryland's license fee is $4,000.00 in even-numbered years, but $2,000.00 in odd-numbered years.[15] Kentucky's Department of Financial Institutions web site lists one lone enforcement action dating back to 2007,[16] from which one might draw the conclusion that either Kentucky is nearly perfect, or there's little point in having a licensure process at all.

There also appear to be notable gaps in the multi-state enforcement framework. As of 2011, each of the major telecommunications providers wants to be involved in the mobile payments industry. Some phone carriers already offer consumers the ability to charge purchases to their phone bill. These carriers have not registered as money transmitters in any state. Startup companies that have secured venture capital financing are frequently assumed to have "enough" capital, and so they too have not been consistently required to apply for licenses, while relatively "undercapitalized" companies without venture capital are examined under a microscope. Such a paradigm ignores the enormous volatility and risk that venture capital brings to a company's management structure and policies, all of which affect consumers in the end.

14 *See http://hawaii.gov/dcca/dfi/reports/report_to_the_legislature_on_money_transmitters.pdf.*

15 *See http://www.dllr.state.md.us/finance/industry/licfees.shtml#moneytran.*

16 *See http://www.kfi.ky.gov/legalresources/enforcementactions/moneytransea.htm.*

The most egregious ongoing violations of money transmission law take place every day when private universities, which cannot be classified as exempt government institutions, allow students to use pre-paid plastic cards to make purchases not just at university-owned dining halls, but at area merchants as well. These programs, with names such as "Crimson Cash" (for Harvard University) and "Cardinal Dollars" (for Stanford University) clearly fall within the scope of money transmission regulation,[17] even if they are managed by third-party administrators, which is frequently the case. In no state are private universities or their program administrators registered as money transmitters. Consequently, the presidents, provosts and trustees of every private university in the nation with such programs (which are exceedingly common) are unknowingly committing federal crimes, and could be incarcerated. To call this state of affairs draconian in the most ridiculous sense is a gross understatement, for these university-sponsored money transmission systems have been designed specifically to give unsuspecting students a safe alternative to high-APR credit cards.

In today's environment, a new issue with money transmission has emerged as well, which is that the statutes are increasingly being written or amended by financial industry lobbyists, who have come to realize that they are a highly effective way to quash potential competitors. In the case of the California Money Transmission Act, which went into effect for existing money transmitters in California as of July 1, 2011, there were two main supporters according to the California Senate Committee on Banking, Finance and Insurance: the Consumers Union, which publishes *Consumer Reports* and aims to be an objective champion of consumer rights, and The Money Services Roundtable, which was the bill's sole sponsor. The latter group has no discernible mailing address, web site or official membership roster, so it's impossible to tell if it is even discrete from the better-known Financial Services Roundtable. What is clear is that The Money Services Roundtable is a lobbying group that counts American Express, Western Union, MoneyGram, and Travelex among its members, and that according to counsel for the Consumers Union, it was primarily responsible for drafting California's new law (formerly Assembly Bill 2789) with the help of the California Department of Financial Institutions, which not surprisingly gave its Commissioner sweeping new powers under the law, including the ability to make up new unwritten requirements for applicants on a case-by-case basis that do not necessarily have to be communicated to the applicants. The Consumers Union effectively served as a rubber stamp to legitimize the legislation, even though none of the policy recommendations for consumer protections that the Consumers Union outlined in a recent white paper about mobile

---

17 Although Harvard University is located in Massachusetts, which does not regulate domestic money transmission, Harvard enrolls students who are legal residents of California, and these students are granted a Crimson Cash balance coming from their own tuition funds by default. According to the The California Department of Financial Institutions, the Money Transmission Act applies not just to transactions within California's physical borders, but all transactions involving legal California residents. Therefore, Harvard's program violates California state law, which itself is a federal offense under 18 U.S.C. § 1960.

payments[18] were included in the final text of the law.

Moreover, there is mounting evidence that despite the countless barriers to entry that regulators have erected around the money services market (sometimes inspired by the established financial services industry), the laws in place are completely ineffective when it comes to actually protecting consumers. The case of GPal, Inc., a money transmission service designed to handle payments for guns, is illustrative in this regard. Though GPal is a California corporation, the Arkansas Securities Commissioner ordered GPal to cease and desist from further money transmission activity in Arkansas after an Arkansas resident complained about a $304.46 funds transfer that failed to materialize.[19] This turned out to be one of several similar complaints from individuals across the country, and the company is now widely believed to be a scam.[20]

Fundamentally, it is foolish to think that companies such as GPal, formed for the exclusive purpose of defrauding the public, are going to go to great lengths and considerable expense to register with government authorities—especially not forty-seven times over. Yet if these fraudulent companies do not register, then there exists no mechanism by which claimants can be reimbursed for their losses, because each money transmitter effectively insures only itself, using the surety bond underwriter (typically an insurance company) as a proxy to lower the cost. Ironically, the bond premiums from other money transmission bonds insure the *bond underwriter* from losses in the event of a default, but not the public! What existing regulations fail to appreciate is the key point of an insurance pool: that the members of the pool must protect *each other* from unknown or unexpected eventualities. Collectively, GPal has cost the members of public untold thousands (or perhaps millions) of dollars, and yet even with forty-seven laws on the books, not a single one of them will lead to the recovery of any public losses.

If money transmission regulations are going to protect consumers, it's important to be clear on what they are being protected from. Is it flight risk, where a money transmitter suddenly takes all of the money in a pooled bank account and disappears to another country? Is it credit risk, where a money transmitter is extending credit but failing to take in enough revenue, causing the company to default on its obligations? Is it fraud risk, where exogenous factors cause the money transmitter to lose substantial amounts of money? It is the risk that the money transmitter itself will be used to support illegal organizations, such as terrorists or drug cartels? Is it the risk that the money transmitter will

18 *See* Mobile Pay or Mobile Mess: Closing the Gap Between Mobile Payment Systems and Consumer Protections *by Michele Jun, Consumer Reports, http://www.consumersunion.org/pdf/Mobile-Pay-or-Mobile-Mess.pdf.*

19 *See* Case No. C-11-0220, *http://www.securities.arkansas.gov/!userfiles/Cease and Desist Order C-11-0220-11-OR01.pdf.*

20 *See http://castboolits.gunloads.com/showthread.php?t=89122.*

adopt misleading and abusive practices involving high fees, as banks have on an increasing basis? In each of these cases, the net worth and bonding requirements do a rather poor job of offsetting the risks involved, if they are even effective at all.

In the case of flight risk, having a lot of money and a license doesn't prevent a malicious operator from running a scam[21] or packing up and leaving[22], so the effect is zero. The best way to select for trustworthy operators is to conduct extensive background checks.

In terms of credit risk, on the surface it seems like a good idea to have a high net worth and surety bonds, but if a very large money transmitter such as PayPal suddenly faces a credit crunch, its customers will see pennies on the dollar from its bonds, making both requirements largely ineffective for large organizations and prohibitively expensive for small ones. Not all money transmitters extend credit, though, so many of them (and probably most) do not face this risk at all.

In terms of fraud risk, this is the most likely problem any money transmitter will face. A cushion is definitely necessary, but it should never have to exceed the total amount of deposits on hand (it's impossible to steal more than the amount in the bank), and is probably more than enough at 10% of deposits. A money transmission statute requiring a minimum net worth of $500,000 in order to manage $10,000 of deposits makes no sense. Fraud is best offset not by a monetary cushion anyway, but by prevention measures, good record-keeping, and careful system design, meaning that *those* attributes should be the legal requirements before obtaining a license. (This would of course require examiners to be well-versed in technical matters, and not just accounting.)

In terms of supporting illegal organizations, once again, the net worth and bonding requirements do nothing to offset the risk. Rich people can allow the transmission of money to *Al Qaeda* or drug cartels just as easily as poor people, and in fact, supporters or affiliates of drug cartels would have no problem meeting the minimum net worth requirements.

In terms of abusive practices, net worth and bonding requirements prevent nothing at all. The companies known for abusing consumers the most in United States are also some of the wealthiest.

In general, new financial companies—even in Silicon Valley where angel investors and venture capi-

---

21 *See* The Talented Mr. Madoff *by Julie Creswell and Landon Thomas Jr., The New York Times, http://www.nytimes.com/2009/01/25/business/25bernie.html.*

22 *See* Billionaire R. Allen Stanford accused of $8-billion investment scam *by Carol J. Williams, The Los Angeles Times, http://articles.latimes.com/2009/feb/18/business/fi-stanford18.*

talists are prevalent—will not be able to meet a $500,000 or even $100,000 tangible net worth requirement, especially when there are annual bond premiums to pay on top of that. A fairly typical startup today raises $15,000 once from angel investors for two or three co-founders to build a product. In California, the bond premiums on $750,000 ($250,000 + $500,000) at 3.00% are $22,500 per year. Discussing net worth at this stage is already pointless, because all other things being equal, the bond premiums push it well below zero before product development has even started. This is why a quick glance at the list of licensed money transmitters in any state reveals a list of companies that are mostly decades or centuries old.

Surprisingly, there does exist an association of money transmission regulators called the Money Transmitter Regulators Association (MTRA), with a stated mission, "to advance the efficient and effective regulation of the money transmission industry."[23] Despite counting members from 43 states plus Washington, D.C., it is unclear what, if anything, this organization has done to promote its goal. At the very least it should be promoting common forms, fingerprinting processes, and financial requirements between the states. The lack of term limits for money transmission examiners, coupled with the small number of applicants and licensees to examine, creates an environment where many government bureaucrats, who comprise the MTRA's membership, lack any incentive to seek change and see enormous incentives to prevent it.

The Solution

It should be clear that the manner in which money transmission regulation has evolved has led to serious structural flaws in the financial system. While regulation of the financial industry is clearly necessary, the current framework protects incumbent corporations and bureaucrats, prevents new entrants into the market, and frequently leaves the public high and dry when a true fraud comes to light.

Good regulation should function in a manner similar in many respects to good parenting. Just as a parent should not start off with an assumption that a child is either infallible or evil, a regulator should neither actively believe, nor be forced into a position where it is effectively mandated, that applicants are guilty until proven innocent. Nor should regulators allow any kind of activity to go unchecked.

Regulators should assess the actual risks that money transmitters pose, not based on completely ar-

---

23 See http://www.mtraweb.org.

bitrary dollar amounts, but based on the real activities of any given enterprise. A money transmitter that issues credit is not the same as a money transmitter that requires pre-funded accounts without exception. Nor is a money transmitter that lets customers walk into a physical storefront the same as an internet startup that authenticates new users based on four different electronic factors before allowing an account to be established. Yet no state money transmitter application currently distinguishes between any of these cases. In fact, every state application assumes from the start that new applicants will have locations in the state, and requirements are usually tiered based on the number of locations. Unless we revert back to the practices of a century ago, most new applicants will have zero locations, save for a web site.

A clear system of risk assessment is needed in order to classify money transmitters and monitor their activities according to risk. One proposed structure might involve a system of points based on risk, and work as follows:

Table 2: Example risk point-based categorization system

Qualifying Attributes	Risk Points
Revolving credit-based product offerings	10
International product offerings	10
Indirect physical verification of customer identity	5
No physical verification of customer identity	10

Table 3: Example risk point-based categorization system

Risk Tier	Qualifying Point Range	Audit Frequency	Annual Fee
I	0 - 10 Points	Annual	$100.00
II	11 - 20 Points	Quarterly	$400.00
III	21 - 30 Points	Monthly	$1,200.00

Though the specific numbers provided here are for illustration only, a unified system based on "risk points" as illustrated in Tables 2 and 3 would be far more adept at changing with technology over time, while appropriately hedging risk based on various tiers of risk-taking behavior.

It is clear that the federal government needs to spearhead an effort to bring money transmission regulation, or non-bank regulation more generally, under one (and only one) roof. Whether that roof is the Department of the Treasury's or the Consumer Financial Protection Bureau's remains to be seen. At the same time, while money transmitters should only have to report to one regulating agency, the only true way to protect consumers is to make use of existing government infrastructure, such as the pooled insurance system provided by the FDIC. The FDIC's track record both as a system and an agency can only be described as enormously successful, and it is absurdly foolish not to take advantage of its robustness given the similarities between stored value products and traditional bank deposits.

What must be avoided is the present situation, in which regulatory uncertainty at both the state and federal levels means that entrepreneurs do not know whether or not applying for state licenses even makes sense. Worse, investors are reluctant to encourage new innovation, leading to a loop of stagnation. Most entrepreneurs avoid the sector completely, while those foolish enough to charge forward face jail as the next best alternative to licensure. This is perhaps why PayPal co-founder Peter Thiel recently stated, "My general analysis of my PayPal experience is that if I knew then everything I know now about the payments space, I would never have started the company. It would be too intimidating."[24]

Therefore, any new federal legislation must clearly supersede each state's existing law and the draconian punishments mandated by the USA PATRIOT Act. It is a national disgrace that legitimate entrepreneurs should have to worry about threats of incarceration, when the executives of the banks responsible for costing the nation trillions of dollars in aggregate in 2008 have been permitted to walk free.

Furthermore, the incredible variance from state to state in terms of the various prerequisites for licensure borders on being unconstitutional, and harmonization is badly needed. As James Madison wrote in Federalist Paper No. 44:

> In addition to these persuasive considerations, it may be observed, that the same reasons which show the necessity of denying to the States the power of regulating coin, prove with equal force that they ought not to be at liberty to substitute a paper medium in the place of coin. Had every State a right to regulate the value of its coin, there might be as many different currencies as States, and thus the intercourse among them would be impeded; retrospective alterations in its value might be made, and thus the citizens of other States be injured, and animosities be kindled among the States themselves. The subjects of foreign powers might suffer from the same cause, and hence the Union be discredited and embroiled by the indiscretion of a single member.

Had the technology existed to transfer funds electronically at the time that Madison wrote these words, he surely would have insisted that as part of the prohibition on states having the "right to regulate the value of its coin," states should also be prohibited from individually regulating the ability

24 *See* PayPal Co-Founder Peter Thiel on Facebook, Bubbles, and Innovation, *http://blog.caplinked.com/?p=411.*

to hold and transmit a unified currency. As it currently stands, though there is but one valid currency in the United States of America, there are nearly as many regulations "as States" affecting its legitimate use.

Conclusions

The regulatory framework used to license money transmitters in the United States started as a necessary but ill-designed reaction to money transmission businesses that were poorly managed or committed outright fraud. The past six decades have seen this legal patchwork evolve into a colossal anti-competitive bungle that clearly violates the spirit of the United States Constitution while prohibiting competition with some of the most predatory companies in the world. The net result is fewer choices for consumers, who are forced to use antiquated technology, and pay high fees for the privilege.

Drastically simplified oversight at the federal level would solve many of the problems with the current framework, but implementing change requires Congressional or coordinated state legislative action. If such action fails to materialize, consumers will suffer and jobs will fail to materialize that otherwise might have finally propelled the United States financial system into the next century.

Appendix: Venture Capital Rejection E-Mails

The following actual e-mails (with contact information removed) illustrate the bind that regulators have created for entrepreneurs: licensure requires investment, but investment requires licensure. Few (if any) investors want to put their money to work paying government fees and backing surety bonds. This dynamic makes it impossible for entrepreneurs to succeed unless they are independently extremely wealthy.

Investor X: July 18, 2011

> Aaron:
>
> Thank you for coming in to share your vision around FaceCash. We genuinely enjoyed meeting you and learning about the product. As promised, I reviewed the opportunity with our General Partners at our weekly Monday meeting. At this time, we are going to respectfully decline the opportunity to invest in the Series A.
>
> As entrepreneurs ourselves, we always appreciated feedback from people around us so that we could continuously learn and improve. In that spirit, let me share what we discussed at the partner meeting. We see lots of opportunity in the mobile payment space and like how you are taking a unique approach to user verification. On the other hand, we were nervous about the regulatory issues and barriers to obtaining licenses necessary in each state. That process, as you described, is not a quick and easy one and is necessary to get heavy traction in user and merchant adoption. Secondly, while we liked the idea of a new spin on mobile payments, we'd love to see you build out more of your team and have a hiring plan before we invest.
>
> Having said all that, we are impressed with the product you've been able to build with such a small team. Additionally, we think that with your market knowledge on payments you are well equipped to continue innovating on business models and product. We freely admit we are often wrong about these things, and would love nothing more than for you to build a big business with tons of happy users using FaceCash on a wide network of payment terminals. Keep in touch as you grow your business—and especially if you get a bunch of traction and are ready to raise another round in the future, at which time we can take another look. We wish you tons of luck, and thanks very much for considering us!
>
> Best regards,
>
> X

Investor Y: July 20, 2011

Aaron,

Thanks for your time yesterday. I enjoyed our discussion and the demo. I had a chance to discuss Facecash.

Notwithstanding the functioning product and broad vision to disintermediate existing payment rails, we have decided to pass. Our concern was that the vertical integration combined with need for regulatory licensing across the country (and world, in the future) would result in a slow roll-out over a long period of time without significant revenue opportunities. Our fear was that this would result in very high capital requirements for the company over time as well as significant pushback from the existing payments vendors.

Please know that our decision is based on a not extensive interaction with you - we are often wrong.

Best wishes with Facecash!

Regards,

Y

About the Author

Aaron Greenspan is the President & CEO of Think Computer Corporation. While attending Harvard College in September, 2003, Aaron created a web site called "The Universal Face Book," also referred to as "The Facebook," inspiring the separate creation of Facebook, Inc. In 2008, he documented the tale in his book *Authoritas: One Student's Harvard Admissions and the Founding of the Facebook Era*. Aaron holds an A.B. in Economics from Harvard College. He can be reached by e-mail at aarong@thinkcomputer.com.

About Think

Think Computer Corporation was founded in 1998 with the long-term goal of developing simple, useful computer software. From its inception through 2001, the company offered IT consulting services to clients nationwide. Today, Think creates products that make businesses and organizations worldwide more productive, effective and efficient, including the FaceCash mobile payment system. Think is on the web at http://www.thinkcomputer.com.

Special Thanks

Thanks to Michael Anderson, Dhruv Amin and Jerry Klein for their assistance compiling the information presented in Table 1. Thanks as well to K. Sabeel Rahman for general insight and support.

Think Computer®

Think Computer Corporation
3260 Hillview Avenue
Palo Alto, CA 94304

telephone +1 415 670 9350
toll free +1 888 815 8599
fax +1 415 373 3959
e-mail think@thinkcomputer.com
web http://www.thinkcomputer.com

Copyright © 2011 Think Computer Corporation. All Rights Reserved.