Banking Law

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Regulatory Perils in the Fast-Growth World of Mobile Payment Apps

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"Paper or plastic? Or smartphone?"

From buying groceries to concert tickets in our technology-driven world, this could be the new catchphrase to describe your payment preference. Consumers purchase products daily: swiping cards, entering PIN numbers and breezing through transactions without thinking about the purchase mechanics. But depending on how and where a consumer pays for a product, there could be seven or more players facilitating that transaction.

Banks have always been one of these players, but other types of companies (especially Internet and telecommunication companies) are entering the payments business, giving consumers more choices about how to purchase products and simultaneously wading into highly regulated areas of activity. While consumers gain new ways of purchasing, they often harbor security and trust concerns, especially for transactions using smartphones.

According to the U.S. Federal Reserve, the United States has the largest payments system in the world. Each day millions of transactions, valued at more than $3 trillion, occur between sellers and consumers. The Federal Reserve, historically tasked with regulating and improving the U.S. payments system, plays a key role in the payments process because most payments underlying transactions ultimately flow between banks. The Federal Reserve acts as the intermediary between banks – debiting the accounts of those banks making payments for their customers and crediting the accounts of those banks receiving payments for their customers.

Behind-the-scenes players facilitate transactions

Let's examine a fan's purchase of concert tickets. If our fan pays cash at the box office, then the only parties are the fan and the box office. If our fan pays by check, then the parties increase to five: the concertgoer and his bank, the box office and its bank and, as an intermediary between the two banks, the Federal Reserve.

If our fan decides to pay using plastic, then the number of players involved increases even more. At the center of the transaction are card networks (Visa, MasterCard or a debit card network). At one end of the transaction is our fan and the issuer of the fan's credit card. There may also be a bank serving that card issuer.

On the other side of the transaction is the box office and the institutions serving the box office, which are a financial institution that is a member of a card network and responsible for the box office's transactions with the card network and, typically, a nonbank payment

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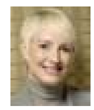

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processor. Nonbank payment processors contract with banking partners and process electronic transactions on their behalf.

Not only are there many parties, but they must satisfy numerous regulations, a few of which are listed at the end of this article. Regulation is often a barrier to entry. But companies entering the payments arena often – at their peril – overlook the challenge of regulatory compliance, as they set their sights on the benefits and opportunities in the business of modernizing payment technology. However, without proper attention and compliance, these regulatory issues will become hurdles, hindering and even halting a company's entry into the industry.

The Internet has already changed the traditional payments structure – pushing more payments into cyberspace. Customers enjoy using their computers, tablets or smartphones to access their bank accounts to pay bills or obtain account information.

With the Internet, new payment networks developed. EBay's PayPal network is an example. On the eBay site, consumers buy products from people they don't know. Using their bank accounts or credit cards to purchase these products required consumers to give sensitive information to an unknown person. PayPal developed a way to solve this problem with a protocol that does not require an exchange of sensitive financial information between consumers.

For our fan, the PayPal network allows him to purchase tickets by instructing PayPal to move funds from his PayPal account into the seller's PayPal account. So, our fan's bank account or credit card information is never disclosed to the seller.

While the PayPal innovation occurred due to a perceived consumer need, the drivers behind many new products are marketers. For example, if our fan decided to purchase his tickets after seeing an Internet ad and clicked on the ad to complete the purchase, then that information could be valuable to advertisers and Internet companies.

Mobile payments on the move, gaining market share

Smartphones have become the starting point for new products that facilitate gathering of this type of data. In September 2011 Google introduced Google Wallet, a mobile application that stores credit cards and offers on your smartphone. The Federal Reserve examined mobile payments trends recently, and in March 2012 reported that other firms are investing in mobile wallet technology, including mobile phone carriers, credit card issuers and payment networks. Yet other types of payments using mobile devices involve accessing web pages through browsers on smartphones or by sending text messages (such as a Red Cross text message donation).

With the rapid expansion of mobile payments, distinct challenges for the industry include the complex legal issues implicated by these systems and products, many of which are not immediately obvious for companies new to the payments industry. Companies and their law firms need the depth of resources to field a team knowledgeable across multiple areas of regulatory disciplines, including financial services, privacy and data security telecommunications regulation, consumer protection and differing state-by-state licensing requirements.

Some of the key regulations applicable are Regulation E (electronic payments), Regulation Z (consumer disclosure for credit transactions) and the Bank Secrecy Act (anti-money laundering and counter-terrorist law). Depending on how the mobile products are structured, providers may be considered to be extending credit to their customers, which would bring into play state-by-state lender license requirements.

There are also overlaps among regulatory agencies. The Consumer Financial Protection Bureau oversees compliance by bank and nonbank financial providers with consumer laws. For mobile payments, concurrent oversight may come from the Federal Trade Commission, which oversees consumer products, and the Federal Communications Commission, which regulates telecommunications providers. State attorneys general are also avid enforcers of consumer protection. Designing a mobile payments system that will withstand scrutiny entails navigating around these and other regulatory regimes.