

P2P Electronic Payments – Emerging Risks

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Together we'll go far

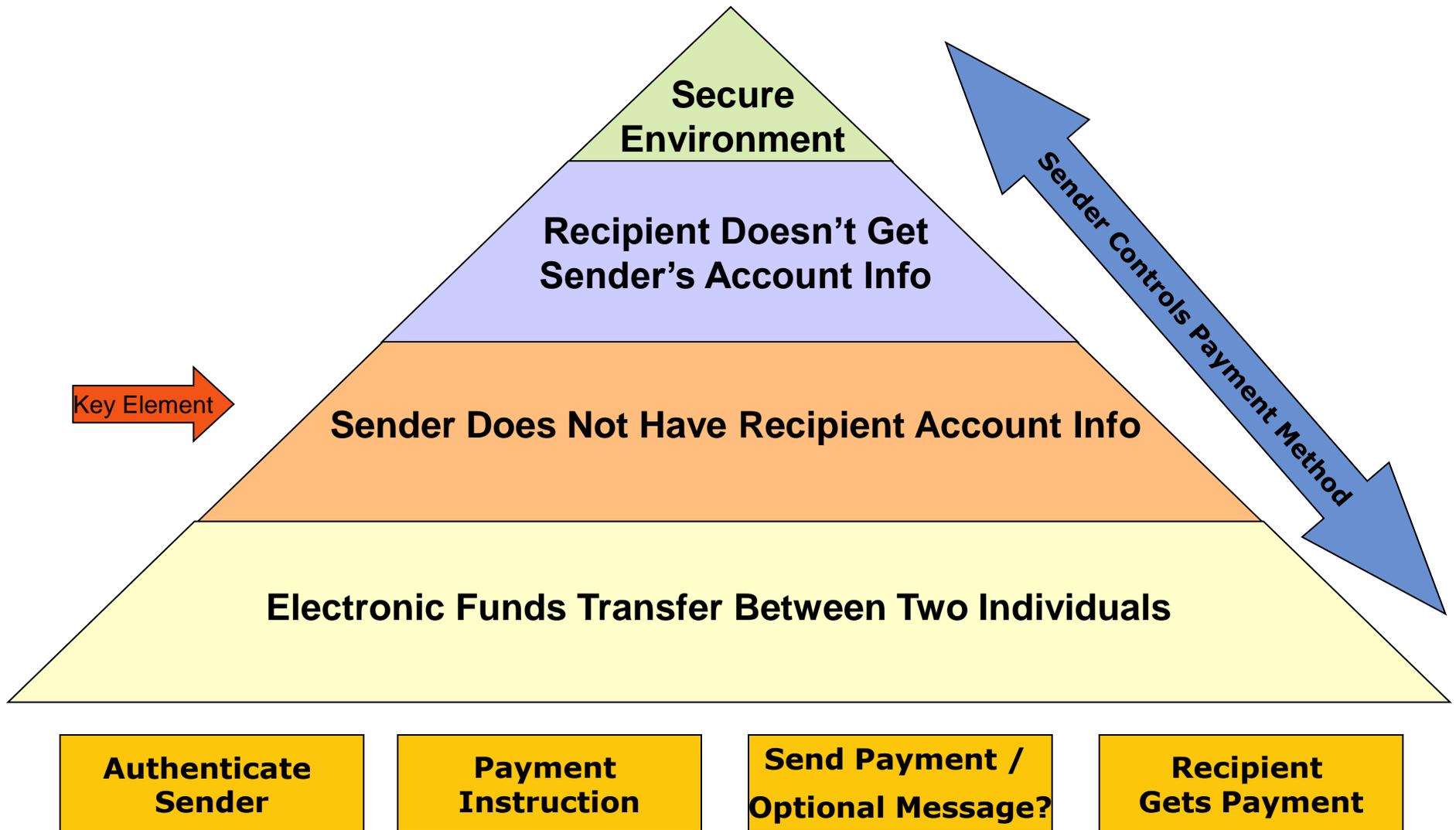


Agenda

- Putting Electronic P2P Products in Context
 - Key Characteristics
 - Some History
- Traditional Risk Factors in a New Environment
- New Risk Factors Introduced by Innovation

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Key Characteristics of P2P



Historical Context

Past as Prologue

PRECURSORS TO MODERN P2P

- **Electronic P2P Products**
 - DigiCash
 - Mondex Smart Cards
 - Others
- **Chief Characteristics**
 - Value “checked out” of financial system and stored on cards or special-purpose storage devices
 - P2P Payments Possible – Primarily In Person
 - Often Characterized as “Electronic Cash”

RISK AND REGULATORY ANALYSIS

- **Baxter Goes Ballistic**
- **ABA Initiative**
 - Extensive analysis of risk and structural issues
 - Seminal Report – “A Lawyer’s Take on the Electronic Purse” – published in The Business Lawyer
- **Federal Reserve Analysis – Application of Regulation E**
- **FinCen – Money Laundering Potential**

Historical Context

Key Lessons

- P2P Payments may be electronic, but they're not cash...
 - Until the value comes to rest in a financial institution account of the intended recipient, the right to receive payment is:
 - An unsecured debt obligation,
 - Owed by the issuer or intermediary who has promised to deliver the value.
 - P2P systems that include traceable, centralized records of the movement of value are, with respect to consumer transactions, subject to the protections of Regulation E – including
 - Right to disclosures,
 - Protection from unauthorized transactions, and
 - Right to periodic statements.

Modern Context

Key Elements

- Low U.S. transmission costs continue to favor centralized payment systems.
- Tools of choice
 - Mobile phones -- especially smart phones -- are now favored by many for managing finances and receiving information.
 - SMS text messages and “instant messaging” are supplanting email with younger users as their primary electronic messaging medium.
- Cell phone numbers, and to a lesser extent email addresses, have become reliable ways to identify individuals to receive targeted messages -- but there are no 100% reliable public directories.

Analyzing Risk

- The proliferation of electronic payment devices and systems is straining the definitions and structure of rights and responsibilities under existing law.
- Key Risk Distribution Issues in a P2P Environment:
 - Unauthorized transactions.
 - Erroneous transactions.
 - Intermediary error.
 - Intermediary fraud.
 - Intermediary insolvency.
 - Discharge of underlying obligation.
 - Disputed Transactions.
- The proliferation of non-financial institutions participating in the payment process has:
 - Outpaced the definitions and distribution of rights and responsibilities in payment systems law,
 - Created confusion concerning the credit risk associated with these participants, and
 - Resulted in a confusing patchwork of state laws concerning the charging of fees and the application of escheat and money transmitter statutes.

Traditional Risks in a New Environment

Illustrations – Intermediary Risk

Intermediary Insolvency

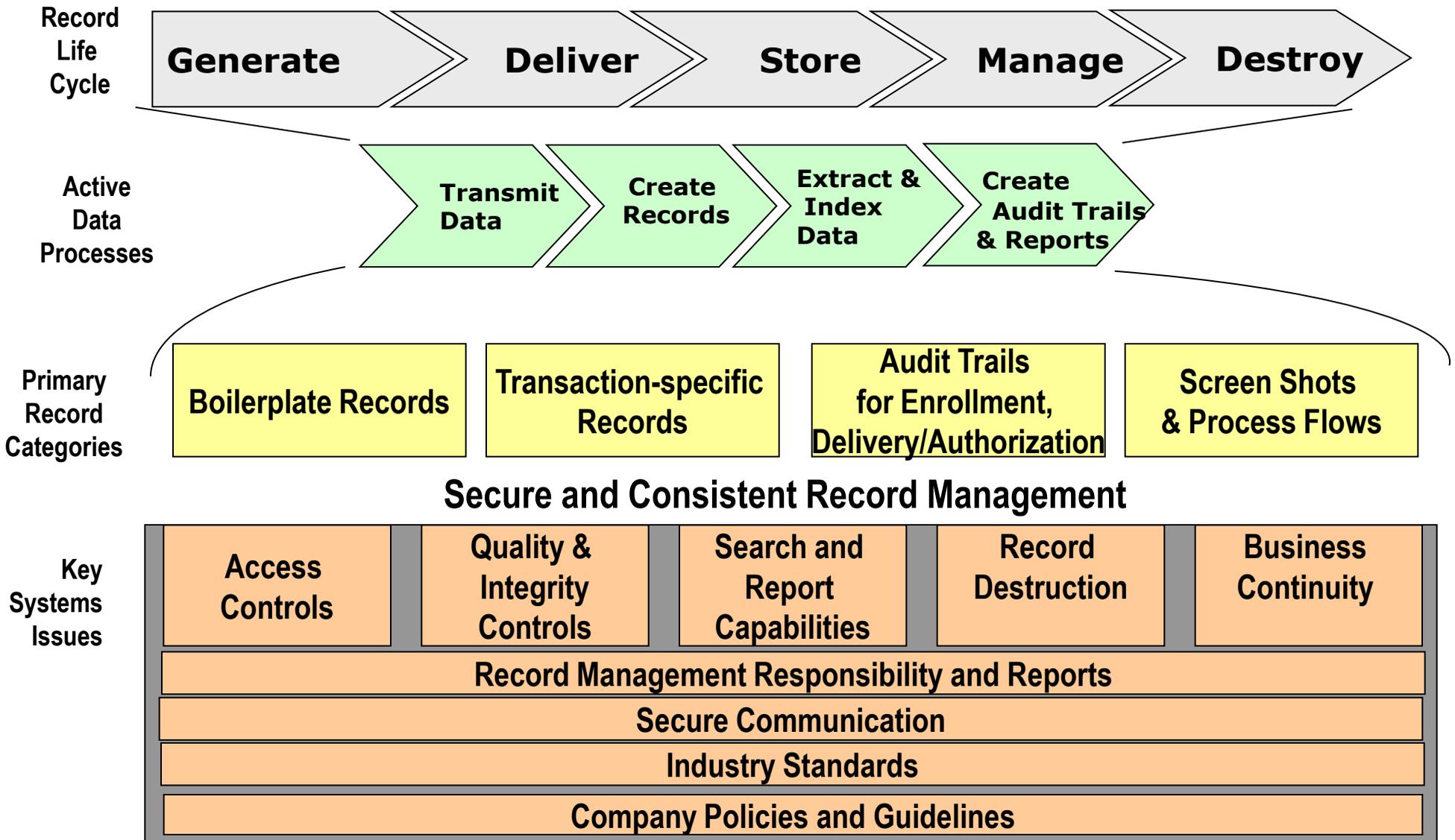
- Allocation of loss for in-process transactions.
- Protection from third-party claims.
- Application of FDIC Insurance – structure of suspense or processing account.

Intermediary Processing

- Transaction tracking/payment confirmation.
- Misdirected payments.
- Responsibility for periodic statements.
- Application of Money Transmitter Statutes.
- Auditing and control standards – who stands in for the FFIEC with non-FI players?

Data Management Examination

The World of the FFIEC Information Technology Examination Handbook



Traditional Risks in a New Environment

Illustrations –NACHA and Payment Rules

Application of NACHA Rules

- Hybrid transactions.
- Payers and payees may be outside definitions of “originator” and “receiver”.
- New “Mobile Payment” Rule does not apply.
- Need for special “P2P” rules under consideration -- But can NACHA enforce them?

Application of Payment System Rules

- Articles 3, 4 and 4A of UCC do not apply.
- Application of Reg. CC rules for “electronic payment” unclear.
- Is underlying obligation suspended once payment initiated?
- How may payment and discharge be traced/proven?

New Risks Introduced by Innovation

Illustrations

Restrictions on Communication with Mobile Devices

- Contracting and Disclosure – Implementation of ESIGN requirements on a smart phone.
- Application of TCPA and the “Satterfield Decision” to SMS Text Messages.

Security of Transaction Devices

- Computer security -- browser security, keystroke monitoring, and temporary data retention on public computers.
- Mobile devices
 - Access to smart phone applications and disparities in pre-distribution security review of new applications.
 - Security of the device itself.

What are the options for addressing emerging risks?

Do Nothing

- If it ain't broke, don't fix it –Let contracting handle open issues.
- Meaningful changes may not be feasible (see UCITA and Article 2 revision process).
- The cost of changing systems and processes to respond to a new payment system regime could be significant.

Tinker

- There are a number of discrete issues that could be addressed by revisions to a combination of rules, laws and regulations.
- Article 4A and/or Reg. E might be expanded to cover some risk distribution issues on a global basis.

Create a New National Set of P2P Rules

- Permits creation of uniform, consistent roles and results for participants in payments system.
- Offers opportunity to re-visit and address risk distribution policy choices.
- Could be drafted by NCCUSL/ALI and offered up to FRB for national enactment – a new model to leverage NCCUSL/ALI?