P2P Electronic Payments – Emerging Risks

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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

Electronic Funds Transfer Between Two Individuals

Sender Does Not Have Recipient Account Info

Recipient Doesn’t Get Sender’s Account Info

Secure Environment

Authenticate Sender
Payment Instruction
Send Payment / Optional Message?
Recipient Gets Payment

Sender Controls Payment Method

Key Element
Historical Context
Past as Prologue

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<th>PRECURSORS TO MODERN P2P</th>
<th>RISK AND REGULATORY ANALYSIS</th>
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<td>Electronic P2P Products</td>
<td>Baxter Goes Ballistic</td>
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<td>• DigiCash</td>
<td>• ABA Initiative</td>
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<td>• Mondex Smart Cards</td>
<td>• Extensive analysis of risk and structural issues</td>
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<td>• Others</td>
<td>• Seminal Report – “A Lawyer’s Take on the Electronic Purse” – published in The Business Lawyer</td>
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<td>Chief Characteristics</td>
<td>• Federal Reserve Analysis – Application of Regulation E</td>
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<td>• Value “checked out” of financial system and stored on cards or special-purpose storage devices</td>
<td>• FinCen – Money Laundering Potential</td>
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<td>• P2P Payments Possible – Primarily In Person</td>
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<td>• Often Characterized as “Electronic Cash”</td>
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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

Record Life Cycle
- Generate
- Deliver
- Store
- Manage
- Destroy

Active Data Processes
- Transmit Data
- Create Records
- Extract & Index Data
- Create Audit Trails & Reports

Primary Record Categories
- Boilerplate Records
- Transaction-specific Records
- Audit Trails for Enrollment, Delivery/Authorization
- Screen Shots & Process Flows

Secure and Consistent Record Management
- Access Controls
- Quality & Integrity Controls
- Search and Report Capabilities
- Record Destruction
- Business Continuity

Key Systems Issues
- Record Management Responsibility and Reports
- Secure Communication
- Industry Standards
- Company Policies and Guidelines

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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?