



# DISCUSSION PAPER

## PAYMENT CARDS CENTER

### **Prepaid Card Markets & Regulation\***

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***Summary:** Prepaid cards, also commonly referred to as stored-value cards, are typically credit card-sized pieces of plastic that contain or represent an amount of pre-loaded value. They include a wide range of payment products, such as gift cards, payroll cards, teen cards, and travel cards. Despite significant product innovations, it is unclear whether and how existing federal and state laws that apply to other financial products (e.g., checks, credit cards, deposit accounts) apply to the different varieties of prepaid cards. Overall, the law in this area is very much unsettled. In an effort to understand the legal and regulatory issues facing prepaid cards, the Center invited Judith Rinearson, chief counsel to American Express' electronic stored-value business, to present a workshop on the topic. This paper provides highlights from Rinearson's presentation. It analyzes the different kinds of prepaid card products on the market and the federal and state laws that potentially apply to them.*

\* The views expressed here are not necessarily those of this Reserve Bank or of the Federal Reserve System. In addition, Judith Rinearson has noted that the views she has stated are her own and should not be attributed to American Express Company.

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## Introduction

Traditional credit and debit cards are not the only plastic payment mechanisms contributing to the decline of paper at the point of sale. Prepaid cards, which include products such as gift cards, travel cards, and payroll cards, are quickly replacing a variety of paper payment products, including gift certificates, travelers' checks, and paychecks. In addition, merchants, banks, and employers are announcing new stored-value-card initiatives almost weekly. Also contributing to the prepaid card buzz are impressive estimates as to the product's potential. MasterCard and Visa, for example, both estimate that the prepaid market could grow to over \$2 trillion and include business-to-business, consumer-to-consumer, and government-to-consumer transactions.<sup>1</sup> Although such volumes are not expected for many years, prepaid card issuers are already being confronted with a myriad of legal issues that threaten to impede the technology's growth. It is unclear, for example, whether a host of federal and state statutes that cover traditional payment products can or should reach prepaid cards. Overall, the future of prepaid card law is unsettled.

In an effort to better understand the developmental and legal issues facing prepaid cards and their issuers, the Payment Cards Center of the Federal Reserve Bank of Philadelphia hosted a workshop led by prepaid card expert Judith Rinearson. Rinearson has been chief counsel to American Express' electronic stored-value business since 1995. This paper provides highlights from Rinearson's presentation and the ensuing discussion. It analyzes the different kinds of prepaid card products currently on the market and the federal and state laws that may apply to them.

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<sup>1</sup> Burney Simpson, "New Markets for 2004: Health-Care and Recurring Bill Payments Look to Reach Tipping Points While Prepaid Cards Move from Red to White Hot," *Credit Card Management*, January 2, 2004, p. 10.

## **Prepaid Cards and Their Market**

A prepaid card, also commonly referred to as a stored-value card, is typically a credit card-sized piece of plastic that contains or represents an amount of pre-loaded value.<sup>2</sup> Unlike credit cards, which draw their value from a line of credit, or debit cards, which draw their value from a checking account, the value on a prepaid card typically comes from money given to the card's issuer (or a designee) prior to its use. Prepaid cards take many forms, including gift cards that can be used at a specific merchant or mall, travel cards that can be used in the same way as travelers' checks, payroll cards that can be used to access one's wages, and "teen cards" that are marketed to those under 18 years to access funds their parents load onto the card.

After briefly describing several stored-value applications, Rinearson presented a prepaid card taxonomy. In her view, it is critical that any discussion of prepaid card regulation be grounded by an understanding of prepaid card operating systems and risks. As such, she proposed a classification system largely based on the size of the universe in which a prepaid card can be used and the risks its issuer faces. In ascending order of risk and complexity, she described four prepaid card systems: closed, semi-closed, semi-open, and open.

### *Closed*

Closed-system prepaid cards are those that can only be purchased from and redeemed at a single merchant (or merchant chain). They include a host of gift-card-type products, such as those offered by Starbucks, Barnes and Noble, and Home Depot. These cards are usually purchased directly from a retailer and, unlike credit or debit cards, are not embossed with the cardholder's name. Rinearson also explained that the cards are typically sold in fixed amounts (e.g., \$25, \$50, or \$100) and are not re-loadable. Although they function very much like paper gift certificates, prepaid cards provide retailers with additional benefits. First, gift card transactions are easier to

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<sup>2</sup> Generally, prepaid cards that have an embedded microchip (i.e., prepaid smart cards) store information about the card's value right on the card. Prepaid cards that have a magnetic stripe generally have a card number that is associated with an account on a separate database. That number is used to track the value associated with the account.

clear and settle than paper gift certificate transactions, as they do not require paper-based settlement and tracking systems. Second, unlike a paper certificate, the card can store any value that remains after its initial use. This obviates the need for merchants to refund cash to consumers who use less than the card's full value. Such a feature likely ensures that most people will either spend more than the face value of the card or never use the card's entire value. Third, gift cards are easier to issue and less susceptible to fraud than paper gift certificates (i.e., they are more difficult to counterfeit). Finally, the information systems that track gift cards enable merchants to gather data on the ways that consumers use such cards. This kind of information can be used to improve merchants' marketing efforts.

Some merchants, however, have had success developing gift-card products that are more than just substitutes for paper gift certificates. For example, Starbucks, which launched its closed-system prepaid card about two years ago, markets the card as both a gift idea and "a fast and convenient way to simplify your busy day."<sup>3</sup> The company reports that it has sold 18 million gift cards and that gift card purchases represent 10 percent of the coffee retailer's transaction volume.<sup>4</sup> Gift card proponents point to this success as evidence that the cards can ultimately increase a merchant's sales volume and simplify its check-out process.

Rinearson explained that merchants, in order to accept closed-system cards, must reprogram their point of sale (POS) terminals. The terminals are usually modified to display the unused portion of the gift card's value so that a clerk can communicate remaining balance information to the cardholder. Despite the costs associated with these modifications, Rinearson estimates that closed-system gift cards, overall, are very profitable. They enhance customer loyalty, save time at the point of sale, and allow merchants to essentially receive payment before providing customers with any goods or services. In addition, merchants that charge consumers "inactivity" fees or strictly enforce card expiration policies may derive additional revenue from

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<sup>3</sup> Starbucks web site: <https://www.starbucks.com/card/default.asp>.

<sup>4</sup> Lavonne Kuykendall, "Gift Cards Take Off, But Fees Are an Issue," *American Banker*, January 14, 2004.

the product.<sup>5</sup> These kinds of fees and the legal challenges they have stirred are discussed later in this paper.

### *Semi-Closed*

Unlike closed-system cards, which are issued by and redeemed at a single merchant, semi-closed system cards are issued by third parties (e.g., banks, money transmitters) and often redeemable at multiple merchants. They often look like credit cards (i.e., they have a magnetic stripe on the back), and they operate on and carry the logo of a branded card network (e.g., MasterCard, Visa, American Express, Discover). For this reason, merchants that already accept traditional credit cards do not need to make any modifications to their POS terminals in order to accept them. Mall cards and resort cards are two examples of semi-closed-system cards. Both can usually be purchased from mall or resort management and used at any on-premises merchant. In general, semi-closed cards are not reloadable and do not carry the cardholder's name. As with closed-system cards, merchants may benefit from the use of semi-closed cards to the extent that a customer spends more than the amount loaded on the card. In addition, such cards may bring customers into a mall or resort shopping area that they otherwise might not visit. From the cardholder's perspective, semi-closed-system cards may obviate the need to carry lots of cash at a mall or while on vacation. In addition, some semi-closed-system cards offer replacement protections in the event the card is lost or stolen.

With a few exceptions, accepting a semi-closed prepaid card at the point of sale is effectively the same as accepting a signature debit or credit card. Upon being presented with the card, the merchant swipes it through a card reader to obtain authorization for the purchase. Information about the transaction is typically sent, via the branded network, to the card's issuer (or a designee). If the prepaid card amount being applied toward the purchase does not exceed the

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<sup>5</sup> A survey by the National Retail Foundation found that consumers age 65 and older spearheaded gift-card growth this past holiday season. To the extent that these consumers use cash instead of credit cards to pay for their gift-card purchases, merchants can also benefit by not paying interchange on cards purchased with cash. "Survey Finds More Consumers Are Buying, Receiving Prepaid Gift Cards," *ATM & Debit News*, November 27, 2003, p.1.

amount on the card, the issuer approves the transaction and the sale is completed. If, however, the amount being applied toward the purchase exceeds the amount on the card, the transaction is denied. Rinearson explained that one of the limitations of using branded card networks to authorize these transactions is the inability on the part of the merchant to know how much value is on the card. So, for example, if a customer presents a prepaid card that contains \$35 of value to make a \$50 purchase and the customer does not inform the merchant of the \$15 shortfall, the merchant will not be able to get authorization to complete the sale. Rinearson indicated that most issuers of these kinds of prepaid cards provide cardholders with a means of checking a card's balance (e.g., by calling an 800 number or by checking a web site). Unfortunately, even if a customer is fully aware of the prepaid card's remaining value, he or she may still be challenged to complete a transaction involving a shortfall. Assume, for example, that the customer above alerts the merchant to the \$15 shortfall and presents a credit card to cover the difference. Some older POS terminals do not allow consumers to use more than one branded card to pay for a single transaction. If the merchant has one of these terminals, consumers must pay for any prepaid card shortfall using cash or check. Although increasingly rare, the so-called "split-tender" problem complicates a transaction that would otherwise provide the merchant with sales above and beyond the prepaid card's value.

Assuming that split-tender is not an issue and authorization is granted, the merchant is then ultimately reimbursed for the purchase amount, less a merchant discount, through the branded network's clearing and settlement process.<sup>6</sup> Generally, non-closed-system prepaid card transactions clear and settle in the same way as credit card transactions. For merchants, however, a prepaid card transaction is generally cheaper to process than its revolving credit counterpart.

Two factors contribute to more favorable transaction costs: lower interchange rates and fewer customer chargeback rights. Under the settlement agreement that merchants reached with

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<sup>6</sup> At the end of each business day, most merchants transmit files to their acquiring bank that contain information about card purchases made at their stores. In most cases, the merchant's acquirer, as soon as it receives this file, credits the merchant's bank account for the amounts owed (less the discount).

the two major associations in the Wal-Mart lawsuit, prepaid cards are classified, for interchange purposes, as signature debit cards instead of credit cards. Because of this classification, merchants are currently paying a lower discount rate on prepaid card transactions than on credit card transactions.<sup>7</sup> The “chargeback” policies that apply to prepaid cards, as opposed to credit cards, also tend to be more favorable for merchants. Under rules promulgated by the Federal Reserve, a cardholder may dispute a credit card charge if, for example, he or she did not make the charge or receive the goods or services associated with the charge. Once a charge is disputed, the issuer of the credit card must investigate the cardholder’s claim and remove the charge from his or her statement until the dispute is resolved. If the dispute is resolved in favor of the customer, the merchant is “charged back” for the purchase amount and must return the money it received for the purchase to the association. In general, however, merchants do not face chargeback liability when they accept prepaid credit cards. This can be a substantial merchant benefit, especially in businesses that typically have high chargeback rates (e.g., mail order and online businesses).

Semi-closed-system prepaid cards also provide benefits to their issuers. Issuers can earn interest on any unused prepaid card value (i.e., float), receive an interchange fee on gift-card purchases, and potentially charge fees for issuance or inactivity or both. In Rinearson’s opinion, these benefits, coupled with the fact that their limited universe of acceptance insulates them from most fraud risk, make semi-closed-system cards a seemingly profitable product.

### *Semi-Open*

From an operational perspective, semi-open and semi-closed prepaid card transactions are very similar. They gain authorization, clear, and settle in the same manner, on the same networks. They offer similar value propositions to merchants (e.g., lower interchange, reduced

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<sup>7</sup> Under the terms of the settlement, MasterCard and Visa were compelled to lower interchange rates for signature debit transactions until January 1, 2004, the date on which merchants were allowed to begin refusing the associations’ debit card products. Although the associations have since announced plans to increase interchange rates, new rate plans are reportedly more favorable for merchants than pre-settlement plans. See Jennifer Bayot, “Final Pact Approved in Long-Running Debit Card Litigation,” *New York Times*, December 20, 2003; Lavonne Kuykendall, “Visa Revamps Signature Debit Rates,” *American Banker*, December 12, 2003.

chargeback liability, and the potential for increased spending), and the cards are similarly limited in their inability to alert merchants as to remaining value. They also provide consumers with similar benefits (e.g., replacement protection and convenience).

The key difference between semi-open- and semi-closed-system prepaid cards is the size of the universe in which they are accepted. While semi-closed cards can be used only at a group of merchants associated with a particular mall or resort, semi-open cards can be used at almost any credit-card-accepting merchant. “Branded” gift cards (e.g., MasterCard GiftCard or American Express Gift Card) are examples of semi-open-system prepaid products. These cards are typically available from banks and can be potentially funded (and reloaded) with transfers from a customer’s checking or savings account. Another example of the semi-open prepaid card is the “incentive” card. Rinearson explained that some companies use semi-open cards as a distribution mechanism for incentive programs. Instead of giving top performing employees cash or checks, employers load value onto a personalized prepaid card. The employee can then spend the money as he or she wishes wherever the card is accepted.

Although semi-open cards are widely accepted, Rinearson explained that they cannot be used to obtain cash from an ATM. They are generally embossed with the cardholder’s name and, as in the case of many branded bank-issued cards, can be reloaded with additional value.

Although the economics of the semi-closed and semi-open systems are similar for issuers, the fraud risk associated with the latter is higher. Given that the card can be used almost anywhere in the world and that it often looks just like a credit card, semi-open cards have the potential to be exploited for more than their value. Thieves, for example, have done so abroad at retailers that do not electronically authorize every purchase or when merchant authorization systems fail. Overall, semi-open prepaid card products are relatively new, and their long-term profitability is unknown. As issuers learn more about the card’s susceptibility to fraud and develop appropriate mitigation strategies, they will be able to better judge its economic potential.



## *Open*

Rinearson concluded her discussion of prepaid card types by explaining how open or open-with-cash prepaid card systems function. Open cards are essentially semi-open cards with ATM functionality. Examples of open-system cards include payroll, teen, and travel cards. Payroll cards are an increasingly popular wage distribution alternative for employers that do not want to go through the weekly or biweekly process of printing and distributing individual payroll checks. A product largely targeted to people with no established banking relationships, the payroll card is funded by an account into which an employer has deposited an individual's earnings. The cardholder can then use the card to buy things at a merchant or to get cash from an ATM. The teen card has been promoted as a tool that parents can use to teach teenagers about financial responsibility. Teen cards are typically funded through a deposit account and can be used by those not yet old enough to have a credit card (i.e., those under 18). Finally, a travel card is essentially a plastic version of a traveler's check.

Open-system prepaid cards have the same advantages and disadvantages for merchants as semi-open cards (e.g., lower interchange rates, inability to know how much value is on the card). For cardholders, open-system cards offer the conveniences and protections of semi-closed cards, with the added benefit of allowing the cardholder to get cash from an ATM. For issuers, Rinearson explained, open-system cards can potentially pose very high fraud risks. For this reason, open-system cardholders are almost never anonymous (i.e., they are typically issued only to "known" individuals). Of the four different kinds of prepaid cards, Rinearson believes that the long-term profitability of open cards will be most dependent on issuers' ability to control fraudulent use.

## *Prepaid Card Markets*<sup>8</sup>

Many merchants, card associations, and issuers argue that the prepaid card market is on the verge of major expansion, and some are already investing heavily in developing new prepaid products. MasterCard, for example, estimates that prepaid cards have the potential to move \$0.5 trillion in traditional consumer payments and \$1.5 trillion in other types of payments (e.g., business to business, government to consumer, etc.).<sup>9</sup> In addition, recent rulings by the Internal Revenue Service have been interpreted as allowing employees access to monies they have saved in their flexible spending and health reimbursement accounts by prepaid card.<sup>10</sup> Approximately 20 million consumers are currently enrolled in health or flexible spending plans, but, prior to this year, very few could access the accounts by card.<sup>11</sup> Minibank Inc. and KeyBank, two providers of health-care prepaid card services, have set out to change this.<sup>12</sup> The two aim to enroll almost 2 million people in such programs by early 2004.<sup>13</sup> The government is also in the process of putting prepaid cards in the wallets of potentially thousands of people. Financial Management Service (FMS), the arm of the U.S. Treasury that provides centralized payment, collection, and reporting services for the government, is implementing a payroll card program for government employees, soldiers, and contractors. FMS hopes that the program will end the float loss associated with the circulation of more than \$2 billion in coin and currency on military bases and ships. It also believes that payroll cards can eliminate the costs associated with transporting and securing cash and clearing and processing meal tickets and money orders. Finally, prepaid proponents cite consumer spending on gift cards this past holiday season as evidence that the

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<sup>8</sup> This section focuses primarily on the size and potential of the prepaid card market. For an economic analysis of their potential impact on the federal budget, the money supply, the payments system, and monetary policy, see William P. Osterberg and James B. Thomson, "Bank Notes and Stored-Value Cards: Stepping Lightly into the Past," Federal Reserve Bank of Cleveland *Economic Commentary* (September 1998) ([www.clev.frb.org/research/com98/0901.pdf](http://www.clev.frb.org/research/com98/0901.pdf)); Jeffrey M. Lacker, "Stored Value Cards: Costly Private Substitutes for Government Currency," Federal Reserve Bank of Richmond *Economic Quarterly* (Summer 1996) ([www.rich.frb.org/pubs/eq/pdfs/summer1996/lacker.pdf](http://www.rich.frb.org/pubs/eq/pdfs/summer1996/lacker.pdf)).

<sup>9</sup> Simpson, p. 10; see footnote 1.

<sup>10</sup> "IRS Rules Changes Improve Health of Prepaid Debit Cards," *ATM & Debit News*, Oct. 2, 2003, p.1.

<sup>11</sup> Ibid.

<sup>12</sup> Ibid.

<sup>13</sup> Ibid.

product is gaining momentum. Consumer spending on gift cards is estimated at more than \$17 billion for the 2003 holiday season, representing 8 percent of retail sales volume.<sup>14</sup>

Despite some high-profile successes and highly optimistic estimations as to their potential, prepaid cards remain a relatively minor and untested method of payment. *The Nilson Report* estimates that prepaid cards, in all of their forms, moved just over \$50 billion in 2002, less than 1 percent of the more than \$5 trillion in consumer payments.<sup>15</sup> Even if prepaid card volume triples by 2007, as *Nilson* estimates, the payment option will still be moving only 2 percent of consumer payments.

Prospects for prepaid growth could be hindered by current attacks on the fees and other features that make these cards a profitable product to issue. In addition to generating interest revenues on the funds that consumers prepay, many issuers of prepaid products generate revenue by charging service or penalty fees. A typical open-system prepaid card, for example, charges a monthly maintenance fee, a card replacement fee, an overdraft fee (if the purchase amount exceeds the card's value), and a dispute fee (if the cardholder disputes a charge on the account). While these fees may not be popular with consumers, they are defended as in line with the kinds of fees consumers typically pay for checking accounts and other financial products. Consumer advocates and legislators have recently focused much of their attention on "dormancy" fees (i.e., fees assessed after the card remains inactive for a certain period of time or expires). These fees allow prepaid card issuers to capture any value on the card that the consumer did not redeem. The industry refers to this unredeemed value as "breakage."<sup>16</sup> The fees are attacked, however, as being unfair, particularly if they begin to deplete the balance soon after the consumer is given the card. States are also attacking the fees on other legal grounds. These theories will be discussed in the

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<sup>14</sup> "Survey Finds More Consumers Are Buying, Receiving Prepaid Gift Cards," *ATM & Debit News*, November 27, 2003, p.1.

<sup>15</sup> *The Nilson Report*, Number 799, November 2003, p.6.

<sup>16</sup> Although no statistics are available on the breakage of prepaid gift cards, a study of prepaid calling cards in 1998 estimated breakage on those cards at more than 50 percent.

next section. Overall, Rinearson explained, beyond closed-system gift cards, the prepaid card market is likely best described as unsettled.

### **Regulation of Stored-Value Cards**

The second half of Rinearson's presentation focused on the various federal and state laws that potentially apply to prepaid products.<sup>17</sup> Interpretations of these laws vary, she explained, and at present, it is unclear how many important issues will be resolved. Regulators and Congress examined some of the federal legal issues in the mid-1990s. At that time, the industry urged the government not to prematurely issue further regulation for fear that a policy misstep might stunt the technology's growth and development.<sup>18</sup> Congress ultimately abided by the industry's wishes.

Since the mid-1990s, however, much has changed. First, prepaid cards, as described above, have become more commonplace. The product is more mature and various prepaid card systems have been established. Second, Congress has enacted legislation (i.e., the USA Patriot Act) that aims to make it more difficult for terrorists to rely on the U.S. payments system. This legislation seems to have implications for certain prepaid card products. Finally, the Treasury Department has ruled that an anti-money-laundering statute applies in part to prepaid cards. This ruling has created additional uncertainty as to the responsibilities of prepaid card issuers. These developments, and developments at the state level, Rinearson explained, have some people in the industry calling for government intervention. They argue that prepaid products are harmed by a lack of standards and clarity. The next two sections describe key legal issues in more detail.

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<sup>17</sup> This paper provides a general overview of the laws that may potentially affect prepaid cards. For an in-depth analysis of legal issues involving prepaid cards, see Judith Rinearson, "Regulation of Electronic Stored Value Payment Products Issued by Non-Banks Under State 'Money Transmitter' Laws," *Business Lawyer* (November 2002), p. 317; Mark E. Budnitz, "Stored Value Cards and the Consumer: The Need for Regulation," *American University Law Review* (April 1997), p. 1027.

<sup>18</sup> Dean Anason, "Nonregulatory Responses Urged for Stored-Value Cards," *American Banker*, July 18, 1997.

## *Federal Laws*

Rinearson began her discussion of federal prepaid card law with the USA Patriot Act.<sup>19</sup> Signed into law just six weeks after the 9/11 attacks, the Patriot Act aims to make it more difficult for terrorists and the organizations that support them to use the U.S. payments system for nefarious purposes. The act requires that financial institutions or card associations or both verify the identities of their customers against lists of known terrorists, establish anti-money laundering programs, and assess the risk of customers using their products to support terrorism.<sup>20</sup> Whether these and other requirements apply to prepaid cards, however, is unclear. For example, the act requires banks to verify the identities of customers for whom it has opened an “account.” The act defines an account as “a formal banking or business relationship established to provide regular services.”<sup>21</sup> It is unclear whether the purchase of a prepaid card establishes an “account” under the act. Other questions Rinearson posed included: If a prepaid card issuer is a licensed “money transmitter” under state laws, does that issuer then fall under the definition of “financial institution” under 31 U.S.C. § 5312? What if the prepaid card issuer is a non-bank? Does the non-bank still have to follow the identification-verification procedures? Should the law distinguish between non-reloadable closed-system cards and reloadable open-system cards? Does the law prohibit the issuance of anonymous prepaid cards? These questions, Rinearson explained, have yet to be answered.

Portions of the Bank Secrecy Act more clearly apply to prepaid card issuers. Concerned about criminal organizations using financial institutions to launder money and obtain funding, Congress passed the Currency and Foreign Transactions Reporting Act of 1970.<sup>22</sup> Commonly referred to as the Bank Secrecy Act, the statute requires financial institutions to, among other

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<sup>19</sup> Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (“USA Patriot Act”) Act of 2001, Pub. L. No. 107-56 (2001).

<sup>20</sup> “The Patriot Act Requires,” *Credit Card Management*, May 24, 2002.

<sup>21</sup> 31 U.S.C. § 5318A(e)(1)(A) (2003).

<sup>22</sup> Amitabh Agarwal et al., “Financial Institutions Fraud,” *American Criminal Law Review* (Spring 2003), p.637.

things, keep records of certain transactions that involve more than \$10,000, register their businesses with the Secretary of the Treasury, and comply with a host of reporting requirements.<sup>23</sup> Although many of the act’s provisions apply specifically to banks, some regulations promulgated by the Secretary of Treasury under the act also apply to “money servicing businesses” (MSBs). MSBs include currency dealers, check cashers, money transmitters, and those that issue, sell, or redeem “stored value” in amounts greater than \$1000.<sup>24</sup> Most MSBs are required to register with the Treasury Department, file reports on “suspicious” activity, and “develop, implement, and maintain effective anti-money laundering program[s].”<sup>25</sup> The regulations, however, explicitly exempt issuers of stored-value cards from the first two of these three requirements.<sup>26</sup> Although the regulation explains that an “effective anti-money laundering program” is one designed to prevent MSBs from “being used to facilitate money laundering and the financing of terrorist activities,”<sup>27</sup> Rinearson indicated that the exact requirements of such a program for non-bank prepaid card issuers remain unclear. She also questioned whether the Treasury’s regulations should apply to closed- and open-system prepaid card issuers in the same way. With much confusion over the Treasury’s requirements, Rinearson believes that additional anti-money laundering regulation is likely for non-bank prepaid card issuers.

Rinearson concluded her discussion of federal efforts to regulate prepaid card issuers by reviewing the Electronic Fund Transfer Act of 1978 (EFTA) and its implementing regulation, Regulation E. The EFTA and Regulation E establish the legal framework that governs the movement of money via electronic systems. This framework covers a wide range of consumer payment activities, including ATM transactions, debit card transactions, direct deposits, and

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<sup>23</sup> Ibid.

<sup>24</sup> 31 C.F.R. § 103.11 (2003). The \$1000 limit includes all transactions for any one person on a single day.

<sup>25</sup> 31 C.F.R. § 103.125 (2003).

<sup>26</sup> 31 C.F.R. §§ 103.41, 103.20 (2003).

<sup>27</sup> 31 C.F.R. § 103.125 (2003).

telephone transfers.<sup>28</sup> Overall, this framework provides consumers with various protections involving statements, receipts, disclosures, and liability limits. Regulation E, for example, limits a consumer's liability for unauthorized debit card transactions as long as the consumer reports any loss or misuse of the card in a timely manner.<sup>29</sup> It also requires foreign ATM owners to provide users with disclosures when it charges them an ATM fee.<sup>30</sup> In 1996, Congress considered extending Regulation E to include prepaid cards. As mentioned earlier, however, the prepaid card industry successfully argued against extension on the grounds that such protections would stifle the product's development.<sup>31</sup> Since that failed attempt, Rinearson noted, rumors persist about efforts to revive proposed Regulation E extensions. She questioned whether Regulation E's protections, which cover "asset accounts" (e.g., checking and savings accounts), should logically extend to branded prepaid cards. She said it is also unclear how such extensions would affect current prepaid systems and procedures. If issuers were forced to adhere to certain sections of Regulation E and, for example, mail monthly statements to prepaid card customers and provide liability protections, she questioned whether many current prepaid business models would be profitable.

#### *State Laws*

Federal laws and regulations, as described above, primarily focus on preventing the use of prepaid cards by criminals. In contrast, Rinearson explained, state laws generally focus on protecting prepaid card consumers from the reckless or seemingly unfair practices of certain prepaid card issuers.

One way states have attempted to regulate prepaid card issuers is through the extension of existing "money transmitter" laws. Approximately 45 states have some form of money transmitter law that generally applies to non-bank businesses that perform payment services for

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<sup>28</sup> 15 U.S.C. § 1693(a) (2003).

<sup>29</sup> 12 CFR § 205.6 (2003).

<sup>30</sup> 12 CFR § 205.16 (2003).

<sup>31</sup> "No Reg for Now," *CardFax*, October 3, 1996.

consumers.<sup>32</sup> Traditionally, these laws have applied to non-banks that issue payment products such as money orders or travelers' checks or that provide wire transfer services. At least 16 states and the District of Columbia, however, have explicitly amended their money transmitter laws to include prepaid card issuers.<sup>33</sup> Other states, Rinearson noted, have asserted that prepaid card issuers are covered by their unamended money transmitter laws. Generally, the laws aim to ensure the safety and soundness of money transmitters. Specifically, Rinearson explained, most of the laws have two key provisions. The first limits the ways in which consumer funds can be used from the time they are received by the transmitter to the time they are spent. For example, some laws require that 100 percent of unused funds be kept in highly secure investments. The second key provision usually addresses the relationship between the licensed transmitter and any of its authorized distributors. For example, some state laws require that any funds given by a consumer to a distributor be remitted to the licensed transmitter within a certain period of time.

Overall, money transmitter laws guard against consumer funds “disappearing” before they are used. As with some of the federal regulations, Rinearson explained, the scope and reach of many money transmitter laws is unsettled. For example, do some states' money transmitter laws actually cover prepaid card issuers? As a matter of public policy, should such laws extend to all semi-open and open prepaid card systems? Should they extend to products that are co-branded with a card association or national card issuer? The answers to these questions remain unclear.

Although relatively arcane, state escheat rules have the potential to significantly affect prepaid card issuers' profitability. Escheat laws, also known as abandoned property laws, require those in possession of the “unclaimed” property of others to surrender that property to the state after attempting to locate the owner. Property subject to escheat includes a wide range of forgotten items, including deposits with rental companies, monies in brokerage accounts, bank

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<sup>32</sup> Rinearson, p. 320; see footnote 17.

<sup>33</sup> The District of Columbia and the following states have amended their laws in such a way: Connecticut, Illinois, Iowa, Louisiana, Maryland, Minnesota, Mississippi, North Carolina, Oregon, Texas, Utah, Vermont, Virginia, West Virginia, Wyoming, and Washington.



deposits, checks that were never cashed, and proceeds of life insurance policies. The time period that must elapse before the property is subject to escheatment varies, depending on the state and the property involved (e.g., 15 years for travelers' checks and three to five years for gift certificates). For general unclaimed funds, 35 states have a five-year period; seven states have a seven-year period; eight states have a three-year period; and New York has just a two-year period.<sup>34</sup> After the property is surrendered to the state of the property owner's last known address, state officials make an attempt to notify the owner, usually via a newspaper advertisement. The rightful owners of property can come forward at any time and recover their property. Until then, the state gets to keep the property and any interest that accrues on it.

As they pertain to prepaid cards, state escheat laws vary greatly. Some states have amended their laws to specifically include "gift cards" in the list of assets that must be surrendered; others have amended their laws to specifically exclude prepaid cards. Some states have asserted that their escheat laws, as written, apply to prepaid cards; still others have admitted that their laws, as written, do not cover them. Another source of uncertainty, explained Rinearson, is the legality of prepaid card dormancy fees and expiration dates. To the extent that fees or an expiration date reduces or eliminates the remaining value on a card, these fees eat away at a potential source of abandoned property (and the interest revenues associated with the property). If states prohibit such prepaid card features and require that unused balances be turned over, issuers' profits would be materially affected. It is also unclear which state should receive the proceeds of an anonymously purchased card and whether federal laws preempt the application of state escheat law to nationally chartered institutions.

Newly enacted state consumer protection laws are also affecting prepaid card issuers. California, Connecticut, Massachusetts, and New Hampshire now regulate prepaid card

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<sup>34</sup> "Escheatment Issues Could Impact Stored-Value Cards," *Card Technology News*, March 7, 1997.

dormancy fees, or expiration periods, or both.<sup>35</sup> Obviously, such laws threaten to significantly alter the prepaid card business model. In Rinearson's view, state legislatures should not treat all prepaid products in the same way. Closed, semi-closed, semi-open, and open-system cards function differently. Prepaid, anonymous gift cards issued by a retailer, for example, do not necessarily require the same level of regulatory oversight as open-system payroll cards. State legislation that does not distinguish between prepaid card type, Rinearson suggested, may stifle development and not help consumers. Disclosure requirements, instead of specific pricing restrictions, should likely be considered. Finally, Rinearson questioned whether federally chartered institutions would have to comply with state consumer protection laws. National banks, she explained, may be able to claim that federal legislation preempts such an exercise of state power.

## **Conclusion**

While prepaid cards are not likely to eliminate the need for paper-based payment mechanisms any time in the near future, they are changing the way many consumers accomplish routine tasks such as giving gifts, accessing earnings, and paying for medical care. As the cards take hold in consumers' wallets, however, it is becoming clear that the legal framework into which they fit is not fully developed. While a lack of rules may have aided prepaid card growth over the past few years, the unsettled nature of the law now threatens the payment vehicle's growth prospects.

As state and federal policymakers contemplate extending, amending, and interpreting relevant laws, Rinearson urged that they be mindful of two prepaid card market attributes. First,

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<sup>35</sup> These states' efforts seem to have encouraged federal lawmakers to consider similar legislation. In a recent press release, Senator Charles Schumer of New York indicated the following: "[The Senator] is considering introducing federal legislation based on new California and Massachusetts state laws that ban monthly fees and let all gift card recipients get the full value of what their loved ones gave them no matter when they use the cards." ([www.senate.gov/~schumer/SchumerWebsite/pressroom/press\\_releases/PR02208.html](http://www.senate.gov/~schumer/SchumerWebsite/pressroom/press_releases/PR02208.html))

not all prepaid cards are the same. There are a wide range of prepaid card products, and each has its own unique set of risks and consumer-protection issues. As such, a one-size-fits-all approach to regulation is not likely optimal. Second, the prepaid card market is not yet fully developed. Issuers, for example, do not yet have enough experience with certain products to fully understand and quantify all of their associated fraud risks. In such a nascent market, government regulation could seriously influence the product's development and jeopardize its growth and economic viability. To the extent to which policymakers consider these market attributes, Rinearson believes that forthcoming regulations will make for a legal environment in which prepaid cards can flourish.