

CLOSING THE LOOP ON PREPAID ACCESS: COMPLYING WITH FINCEN'S PREPAID ACCESS RULE IN A DIGITAL ENVIRONMENT

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Prepaid access vehicles have become pervasive in today's world. Among other things, such devices provide consumers with the ability to load and store funds to be used for future purchases of products and services at various vendors, facilitating efficient and convenient cash-free, and even card-free, transactions. Over the past few years in particular, there has been tremendous growth in the number and nature of retail companies offering prepaid access devices for purchases that can be made from almost anywhere in the world, through websites and mobile phone applications. For example, today's vacationing consumer can load funds into various applications via a phone, and then, order clothes to be delivered upon arrival, buy food en route, and purchase new music or audiobooks for the journey.

To keep pace with consumer demand for instant purchasing power and to expand retail reach, companies are offering novel means of using prepaid access, often in tandem with other retail partners seeking to benefit from synergies. Although many of the innovative prepaid access

approaches have been pioneered by start-ups and emerging fintechs, well-established businesses, including retail giants, also are expanding their reach through creative prepaid offerings.

Many new entrants to the prepaid space are encountering a regulatory regime with which they have not had to wrestle in their existing business operations. Specifically, the Financial Crimes Enforcement Network (FinCEN), an agency of the U.S. Treasury Department, regulates "providers" and "sellers" of prepaid access as part of its oversight responsibilities for various entities covered by the Bank Secrecy Act (BSA). Despite the name, the BSA—and FinCEN's jurisdiction—are not limited to banks. The activities of many nonbank entities are regulated and the applicability of BSA requirements should be fully considered before prepaid offerings are launched, as compliance can be a time-consuming and costly endeavor.

The foundational question is whether these requirements will apply at all. Companies meeting the definition of either a "provider" or a "seller" ordinarily are covered by FinCEN's regulations. However, FinCEN has created an exemption for "closed loop" prepaid arrangements into which many companies seek to structure their operations. Determining whether a prepaid arrangement falls within this exception can be a challenging analysis, as FinCEN's guidance contains significant ambiguities. When the exception is applied to partners operating in a digital space, these ambiguities are often amplified because, in many ways, the regulatory framework has not kept pace with innovation.

Ambiguities notwithstanding, timely consideration of applicable regulations is important. Failure to comply with FinCEN's requirements,

absent cover from an applicable exception, could subject a company to potential enforcement action by the agency, including civil money penalties. Other business impacts also could be significant. Such action may draw the attention of other regulators on unrelated compliance issues. Moreover, regulatory action could result in reputational damage and attendant negative impacts on relationships with business partners and service providers. For example, service providers in the financial sector may be reticent to engage with a company that has been cited for BSA compliance deficiencies, regardless of whether those issues have been timely and fully remediated.

If issues pertaining to BSA applicability are considered early in product design, they may drive the design, enabling the company to craft a product that will not subject the company to time-consuming and costly BSA compliance enhancements, or even re-engineering. If the operations cannot be structured to fit within the exception, the company will need to undertake steps to comply with FinCEN's regulations, but at the very least, the company will be able to properly prepare for the new regulatory regime that it may face. Such steps would include allocating appropriate lead time and more fully understanding the costs that may be associated with the product.

The complex legal issues associated with application of the closed loop exception in digital environments are discussed in further detail below, and in view of the high stakes that may be associated with noncompliance, should be given careful consideration.

MEANS OF OFFERING PREPAID ACCESS

There are many potential examples where FinCEN's regulations intersect with digital products and services. They may include the following scenarios and many others:

- A company offers an app-based wallet that may be loaded with funds. The funds can be used to purchase goods at the company's brick-and-mortar locations and on its website. The funds also can be used to purchase goods at certain other entities' brick-and-mortar locations and *those* entities' websites, even though the companies are not otherwise affiliated through common ownership. The host company substantially increases brand recognition, loyalty, and may reap numerous other benefits by facilitating a streamlined payment vehicle—its application.
- A company offers an app-based wallet that may be loaded with funds. The funds may be used to purchase goods and services from the company who hosts the application as well as a network of other, unaffiliated merchants who share a common business purpose. The host company deepens customer relationships by allowing customers the ease of paying for products and services encountered at the same event (i.e., a concert), on the same trip (i.e., a vacation), or for the same type of service (i.e., restaurants).
- An online vendor selling its own products on its website offers products from separate

vendors on its website. The customer can purchase the products from the online vendor and the separate vendors using funds it loaded into a single account. From the customer perspective, purchases from the different vendors occur through one transaction. The host company benefits in ways which include customers returning to its site through purchase of products it does not produce. This setup is commonly referred to as a digital marketplace.

Whether FinCEN's regulations apply to these and similar scenarios will depend on how an individual prepaid arrangement is constructed. Areas of focus may include the number and location of participating merchants, whether the company central to the prepaid arrangement is making the parameters and details of the setup known to customers using the prepaid access devices, and the purpose underlying the arrangement.

LEGAL BACKGROUND

Overview

The BSA¹ is primarily a recordkeeping and reporting regulatory framework for covered institutions designed to provide information to law enforcement that may assist, among other things, in criminal investigations involving money laundering, terrorist financing, tax evasion, and other illicit conduct.² The BSA has been subject to a series of legislative enhancements since its original enactment in 1970; most recently, the USA PATRIOT Act³ expanded the BSA's coverage to a host of nonbank financial institutions. FinCEN's implementing regulations, in turn, place substantive BSA obligations on these nonbank institutions. Among the covered

institutions are money services businesses (MSBs).⁴ Under FinCEN's regulations, if an entity is a "provider" or a "seller" of "prepaid access," the entity is a MSB⁵ and will be subject to requirements discussed in more detail below.⁶

To determine whether compliance with FinCEN's MSB requirements is mandated, a company must first answer the threshold question of whether it is a "provider" or "seller" of prepaid access. The current prepaid access regulatory regime was implemented by FinCEN's July 2011 Prepaid Access Final Rule, which generally became effective in September 2011.⁷ In issuing the Final Rule, FinCEN noted that the Rule represented an "effort to establish a more comprehensive regulatory regime over an industry in which technological advances had outpaced existing regulation."⁸ Due to the maturation of the prepaid access market, the agency concluded in 2011 that prepaid access warranted commensurate BSA regulation with other MSB categories.⁹ To address questions raised following the Final Rule's implementation, FinCEN issued guidance as FAQs in November 2011 (2011 FAQs)¹⁰, and issued a supplemental set of FAQs in March 2016 (2016 FAQs) in an attempt to address recurring issues.¹¹

Despite the recency of the Rule, and the supplemental guidance, the rapid pace of technological advances has continued to outpace regulation. As discussed below, this is particularly true in connection with novel prepaid access arrangements in the digital space.

Prepaid Programs and Prepaid Access

FinCEN's regulatory definitions are central to determining whether an entity is a covered "provider" or "seller" of prepaid access.¹² Both the

“provider” and, in part, the “seller” definition, depend on the existence of a “prepaid program.” Without a “prepaid program,” an entity will not be considered a “provider” and may be able to avoid inclusion in the definition of “seller” as well. As defined by FinCEN, a “prepaid program” is “an arrangement under which one or more persons acting together provide(s) prepaid access.”¹³

A “provider” under FinCEN’s regulations is the “participant *within a prepaid program* that agrees to serve as the principal conduit for access to information from its fellow program participants.”¹⁴ As relevant to this article, one way an entity can be a “seller” under FinCEN’s regulations is if it “receives funds in exchange for an initial loading or subsequent loading of prepaid access” and sells that prepaid access “*of-fered under a prepaid program . . .*”¹⁵

FinCEN’s regulations specifically except several types of arrangements from the “prepaid program” definition.¹⁶ The most relevant exception here is for closed loops: an arrangement will not be a “prepaid program” if it “provides closed loop prepaid access to funds not to exceed \$2,000 maximum value that can be associated with a prepaid access device or vehicle on any day.”¹⁷ Despite FinCEN’s bright-line monetary threshold, ambiguities spring from the nested term “closed loop prepaid access,” defined as “access to funds or the value of funds that can be used only for goods or services in transactions involving a defined merchant or location (or set of locations), such as a specific retailer or retail chain, a college campus, or a subway system.”¹⁸ FinCEN further nested within *that* definition the phrase “defined merchant or location (or set of locations),” which is subject to differing interpreta-

tions that were not clarified by FinCEN at the time the phrase was introduced in 2011.¹⁹

Defined Merchant or Location

The Final Rule’s preamble—normally a window into an agency’s thinking—provides limited insight into the definition of defined merchant memorialized in the regulation. FinCEN stated in 2011 that it specifically sought to “clarify” that a “defined merchant may comprise a set of affiliated retailers or retail chains.”²⁰ The agency explained in the preamble that during the rule drafting process, it relied on public comments from a “broad range of American retailers,” who together generally advised that closed loop prepaid access was traditionally viewed as usable “within a narrowly-defined universe of entities.”²¹ These commenters advised that such a “narrowly-defined universe” could be composed of, for example, a group of retailers “linked by common ownership, corporate affiliation or geographic proximity.”²²

Several years later, FinCEN dedicated a FAQ to address questions regarding the term “defined merchant.” In its 2016 FAQs, FinCEN indicated “defined merchant” is broader than entities linked through corporate affiliation. Specifically, “defined merchant” includes “additional unaffiliated partner merchants” joined for the “limited purpose of providing a closed loop prepaid access program.”²³ The FAQ provides an example that would pass regulatory muster: a family entertainment company offers a “get-away weekend” featuring partners providing theme park admission, lodging, dining, and travel arrangements.²⁴ The company informs purchasers of its get-away weekend partners in media promotions, websites, and via marketing materials.²⁵ As a result, the

partners are identified and made known explicitly to the purchasers, and FinCEN concludes that “the standard of a ‘defined merchant’ has been met.”²⁶

This FAQ also illustrates various means by which participating merchants can be identified to consumers in closed loop arrangements. These means seemingly would include adding partners’ names, logos, or trademarks on prepaid access devices themselves, in accompanying materials, or through referrals to public websites.²⁷ Regardless of the chosen means, FinCEN concludes that “[a]s long as the universe of merchants is identifiable and articulated to the purchasing public, and the partner merchants are joined for the limited purpose of providing a closed loop prepaid access program, such an arrangement falls within the term ‘defined merchant.’”²⁸

DIFFICULTIES IN APPLYING FINCEN’S DEFINITIONS TO NEW FORMS OF OFFERING PREPAID ACCESS

Since 2011, when the Final Rule was issued, commerce has moved beyond physical devices like gift cards or gift certificates, and once again, it is evident that “technological advances ha[ve] outpaced existing regulation” in this space.²⁹ Accordingly, even though FinCEN issued a specific FAQ relating to the scope of a “defined merchant,” ambiguities remain when applying FinCEN’s guidance in the context of digital marketplaces and application-based prepaid arrangements. As described below, there are open questions about: (i) the outer limits of numerical and/or geographical expansion of the definition; (ii) the standards for disclosure of participating merchants to consumers; (iii) the permissible

purpose(s) of the arrangement; and (iv) the extent that the term “defined location” covers non-physical locations.

Whether a particular prepaid arrangement will qualify for the closed loop exception, ultimately, will be driven by the nuances of the arrangement’s design—factors that must be carefully evaluated in view of regulatory ambiguities.

Numerical and Geographic Boundaries

The preamble to the Final Rule suggests that FinCEN struggled to demarcate where along the spectrum an arrangement would fall outside its permissible scope with respect to defined merchants or locations. It appears that at a minimum, FinCEN originally intended its exception to be somewhat limited in terms of number of merchants and relative locations. The examples listed in the regulatory definition—a retailer or chain, college campus, or subway system—are limited in either number or by geographic proximity, or both. However, the preamble’s affirmation that a “defined merchant” includes a “set of affiliated retailers or retail chains” reasonably can be read to expand the numerical and geographic boundaries beyond the definition’s examples.

FinCEN clarified in 2016 that permissible arrangements also could include *unaffiliated* merchants, a significant definitional expansion. Inclusion of unaffiliated merchants within a permissible closed loop could be read to imply that FinCEN’s initial focus on numerical or geographic limits transitioned to a more elastic standard for determining a “defined merchant.” The outer limits of a more elastic definition remain unclear, but it stands to reason that the greater the number of merchants, the more risk

that an arrangement will fall outside of the definition of a defined merchant or location.

Disclosure Methods to Consumers

The 2016 FAQs suggest that FinCEN also may consider more than numeric or geographical factors when evaluating whether a prepaid arrangement falls within the regulatory parameters. In these FAQs, FinCEN states that the “universe” of merchants must be “identifiable and articulated to the purchasing public.” Accordingly, it would appear that the degree to which merchants are identified and disclosed to the public plays into the analysis of whether merchants are defined, and that such factors may even provide some cover where an arrangement includes an expansive number of merchants scattered geographically.

FinCEN delineates several methods through which it understood, as of 2016, existing merchants enumerated participating merchants or directed customers to relevant information. The space between these cited examples and the governing standard—“identifiable and articulated”—remains somewhat gray under certain factual scenarios, but the agency has provided some guideposts that provide a good starting point. The implementation of means to identify and articulate participating merchants could have significant operational impacts on the design and roll-out of a particular product or service, making this area crucial at the preliminary planning stages.

The Permissible Purposes of Such Arrangements

As noted above, FinCEN provided that so long as “the partner merchants are joined for the limited purpose of providing a closed loop pre-

paid access program,” the defined merchant standard would be met. However, the agency has not clarified the meaning of the phrase “limited purpose” for which unaffiliated merchants must be joined. This is notable because today’s merchants partner in arrangements of varying degrees of complexity, allowing participants to maximize synergies in marketing, advertising, outreach, payment processing, and product distribution, among other things. These activities go beyond mere acceptance of payments and complement what may still be the *primary* purpose of the arrangement—offering prepaid access.

Neither FinCEN’s rule nor its guidance have provided a bright line on when limited purpose becomes something other than providing prepaid access, especially where an arrangement has features which maximize economies of scale and other business strengths. Making matters more complex, if the joined merchants allow payment for products and services through means other than prepaid access, would this further erode a conclusion that the merchants are aligned for the “limited purpose” of providing prepaid access?

Interpreting the phrase “limited purpose” in a manner that is unduly narrow could severely constrict business partnerships that incorporate prepaid access among a suite of benefits offered by the cooperative effort. The question, as with many other aspect of the Final Rule and FinCEN’s guidance, as applied to a rapidly evolving digital world, is where the line should be drawn.

Meaning of “Defined . . . Location[s]”

Despite the focus on “defined merchant” in FinCEN’s guidance, that term is not the only legal avenue to accessing the closed loop exception. FinCEN’s regulatory definition of

“closed loop prepaid access” depends on access to funds used in transactions that may involve a defined merchant *or* a “defined . . . location (or set of locations).” Although on the surface this may appear to be a more straightforward path for qualifying for an exception, FinCEN has not provided any specific guidance regarding the phrase “defined . . . location (or set of locations).” Among other questions, it is unclear whether locations must be physical, or whether a “defined . . . location” could include digital locations such as websites or other electronic “locations.” In today’s digital environment, however, it stands to reason that electronic “locations” should be included: if a consumer views him or herself as purchasing goods from a vendor, there does not appear to be a strong argument that the purchase location’s existence as a brick-and-mortar storefront or a virtual location is of importance, so long as the location is defined.

If FinCEN interpreted its definition of “closed loop prepaid access” to mean access to funds that can be used for goods or services in transactions involving a defined set of *websites*—fitting website into the regulation’s term “defined location”—a company may be able to bypass the difficulties interpreting “defined merchant,” a significant benefit for vendors participating in a digital marketplace concept described above.

CONSEQUENCES OF GETTING IT WRONG

As noted above, the consequences of failing to interpret the protective scope of the closed loop exception can be significant. Substantive requirements attendant to MSB status under the BSA include registration with FinCEN,³⁰ development and implementation of a BSA compliance pro-

gram,³¹ and certain reporting³² and recordkeeping obligations.³³ An erroneous determination that the BSA does not apply—obviating MSB registration—could cause a series of derivative violations. Such an entity would not have implemented an effective BSA compliance program, filed required reports, or retained required records. FinCEN’s enforcement authority for violations of its regulations includes assessment of civil penalties up to \$8,249 per day for failure to register.³⁴ The agency can assess much higher monetary penalties for willful or grossly negligent recordkeeping violations, patterns of negligent violations of the BSA’s implementing regulations, or willful violations of BSA requirements, among other things.³⁵

OTHER INTERRELATED LEGAL CONSIDERATIONS

While not the focus of this article, there are several other, related legal considerations attendant to entering the prepaid access space that reinforce the need to conduct a comprehensive analysis of a proposed arrangement early in the development stages. First, if the company is involved in the acceptance and transmission of funds, it may fall within FinCEN’s definition of a “money transmitter”—rendering the entity an MSB regardless of its status as a “provider” or “seller.”³⁶ Second, companies may also have to register with state regulators under state money transmission laws, which, to varying degrees, incorporate prepaid access (or stored value), may or may not include closed loop exceptions, and may or may not track with FinCEN’s language.³⁷

CONCLUSION

FinCEN’s issuance of new and updated guid-

ance in this space would benefit companies offering innovative prepaid access devices. As with other aspects of the BSA, the prepaid access regulations could use further modernization and supplementation to account for technological developments. Recent Congressional action and regulatory pronouncements have signaled that BSA changes may be on the horizon, but issuance of additional guidance from FinCEN on this topic is unlikely. While informal guidance from FinCEN can be requested, any responses received may not be timely to keep up with business operations, or may provide insufficient comfort to legal or compliance departments opining on the product or service offerings.

Due to the difficulty of interpreting FinCEN's guidance and the stakes involved, the best corporate strategy is to be proactive in evaluating and addressing risk. As a first step, we recommend completing a comprehensive analysis of FinCEN's regulations, as applied to the facts and circumstances of any prepaid access arrangement, and do so as early in product development as possible. Undertaking such an analysis will allow a company to determine whether there are ambiguities related to application of the closed loop exception, and if so, the magnitude of those ambiguities. Once that analysis is completed, a company can determine its level of comfort with application of the exception and the risk it is willing to take if the answer is unclear. Moreover, if an analysis is conducted at the product design phase, modifications can be implemented to the arrangement's design that may result in closer alignment with regulatory expectations, even in a regulatory environment where such ambiguities remain.

Insofar as a company seeks to rely on the

closed loop exception, contemporaneous documentation of why the company concluded that the exception applies is also recommended. Documented analysis can be extremely helpful in demonstrating to regulators that thorny legal issues were considered and the company operated in good faith in relying on the exception, if the company's interpretation ultimately is challenged.

ENDNOTES:

¹31 U.S.C.A. § 5311 *et seq.*, 12 U.S.C.A. §§ 1829b, 1951-1959.

²*See generally* 31 U.S.C.A. § 5311.

³Pub. L. No. 107-56, 115 Stat. 272 (2001) (codified as amended in scattered sections of the U.S. Code).

⁴31 C.F.R. § 1010.100(t)(3).

⁵*Id.* §§ (ff)(4), (7).

⁶*See generally* 31 C.F.R. Part 1022.

⁷FinCEN, *Bank Secrecy Act Regulations—Definitions and Other Regulations Relating to Prepaid Access*, 76 Fed. Reg. 45403 (July 29, 2011).

⁸*Id.* at 45404. At that time, FinCEN observed that prepaid access was “becoming increasingly pervasive in American commerce, far more so than in the late 1990s when the original MSB categories were established.” *Id.*

⁹*Id.*

¹⁰FinCEN, *Frequently Asked Questions: Final Rule—Definitions and Other Regulations Relating to Prepaid Access* (Nov. 2, 2011).

¹¹FinCEN, FIN 2016-G002, *Frequently Asked Questions Regarding Prepaid Access* (Mar. 24, 2016).

¹²Prepaid access is defined as “[a]ccess to funds or the value of funds that have been paid in advance and can be retrieved or transferred at some point in the future through an electronic device or vehicle, such as a card, code, electronic

serial number, mobile identification number, or personal identification number.” 31 C.F.R. § 1010.100(ff)(4)(iii).

¹³*Id.* § 1010.100(ff)(4)(iii).

¹⁴*Id.* § (ff)(4)(i) (emphasis added).

¹⁵*Id.* § (ff)(7)(i) (emphasis added). Separately, an entity can be a “seller” if it sells prepaid access to funds that exceed \$10,000 to any person during any one day and the company “has not implemented policies and procedures reasonably adapted to prevent such a sale.” *Id.* § (ff)(7)(ii). Importantly, this definition does not depend on the definition of “prepaid program.” In fact, the definition specifically notes that the sales to funds that exceed \$10,000 that cause an entity to fall into this definition can “include[e] closed loop prepaid access.”

¹⁶*See generally id.* § (ff)(iii).

¹⁷*Id.* § (ff)(iii)(A). The monetary threshold for the exception is straightforward, setting a maximum dollar amount; FinCEN’s 2011 FAQs explained that this threshold attaches to each device or vehicle, and companies need not aggregate separate devices or vehicles bought by an individual in a single day. 2016 FAQs, at 6. However, FinCEN also clarified that if the prepaid arrangement permits individual or cumulative reloads on a device or vehicle that, in total, allow more than \$2,000 on that device or vehicle, the arrangement no longer qualifies for the exception. *Id.*

¹⁸31 C.F.R. § 1010.100(kkk).

¹⁹We note that a separate exception to FinCEN’s definition of “prepaid program” may be available if a company is willing to limit its arrangement to domestic use and permit only depository sources for loading funds into user’s accounts, among other limitations, but this article does not address that separate exception in detail because such structural limitations may inhibit the usability and convenience of a prepaid access arrangement. *See id.* § (ff)(4)(iii)(D). Under this exception, the arrangement must provide prepaid access solely to funds “not to exceed \$1,000 maximum value and from which no more than \$1,000 maximum value can be initially or subse-

quently loaded, used, or withdrawn on any day through a device or vehicle,” and cannot permit (i) funds or value to be transmitted internationally, (ii) transfers between or among users of prepaid access within a prepaid program, or (iii) loading additional funds or the value of funds from non-depository sources.

²⁰*See* 76 Fed. Reg. at 45413.

²¹*See id.* at 45407.

²²*See id.*

²³2016 FAQs.

²⁴*Id.*

²⁵*Id.*

²⁶*Id.*

²⁷*Id.*

²⁸*Id.*

²⁹76 Fed. Reg. at 45404.

³⁰31 C.F.R. § 1022.380.

³¹*Id.* § 1022.210(a).

³²*See, e.g., id.* § 1022.320 (setting out procedures for filing suspicious activity reports with FinCEN).

³³*See, e.g., id.* § 1022.420 (setting out record-keeping requirements for providers to maintain access to certain transactional records generated in the ordinary course of business that would be needed to reconstruct prepaid access activation, loads, reloads, purchases, withdrawals, transfers, and other prepaid-related transactions).

³⁴*See* 31 U.S.C.A. § 5330(e); 31 C.F.R. 1010.821(b), Table 1.

³⁵*See* 31 C.F.R. 1010.821(b), Table 1.

³⁶*See id.* § 1010.100(ff)(5).

³⁷*See, e.g.,* Cal. Fin. Code § 2003(q) (defining “money transmission” to include, among other things, “selling or issuing stored value”).