Navigating High-Risk Industries

Payments Law Virtual Bootcamp – June 9, 2021

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Today's Discussion

- Defining and understanding the legal risk

- High Risk Spotlight:
  - Tech Repair
  - Mobile Gaming
  - COVID-Related Products and Services
  - Recurring Billing
  - Cryptocurrency
  - CBD and Cannabis
  - Adult
  - Multilevel Marketing

- Risk management: What do regulators expect?

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Defining and Understanding Legal Risks

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What Does High Risk Mean?

- Depends on the bank/processor, but could include:
  - Higher risk of fraud to the payments network or its participants
  - Higher risk of financial loss to the acquirer or processor (chargebacks, high tickets)
  - Higher risk of harm to consumers (questionable sales and marketing practices)
    - Examples: Telemarketing, negative option, MLMs, scams
  - Higher risk of selling something of questionable legality
    - Examples: Adult, cannabis, drug paraphernalia
  - Higher risk of reputational damage to the acquirer or processor

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What are the Risks?

Financial Loss

- Loss is the entire transaction
- Chargebacks, fees and assessments
- In fraud situations, time and expense lost to investigate and remedy

Consumer Loss

- Loss is the total volume of sales processed
- Plus, potential fees paid to third parties (sales agents, banks)
- Potential loss of reserves and suspended funds to the government
- Consumer class action lawsuits
- Criminal liability (illegal products)

Reputation & Operational Damage

- Loss of confidence/trust
- Increased susceptibility to law enforcement or lawsuits
- Court-ordered operating requirements

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Example 1: Loss of Reserves

Hypothetical:

- You underwrite and onboard a multilevel marketing (MLM) company.
- Six months later, the FTC gets a court to shut down your merchant with an asset freeze, appointment of a temporary receiver, and preliminary injunction.
- You receive letters from the receiver asking for a sworn statement about the merchant accounts you have for the merchant and how much money is in the reserve account.
- You are holding $800,000 in reserve funds. The FTC's receiver demands that, pursuant to court order, you turn over **all** the reserves to the receiver.
- What do you do?

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Example 2: Responding to a Civil Investigative Demand (CID) or Subpoena

Hypothetical:

- Your payment facilitator boards a sub-merchant merchant that sells CBD products.
- The sub-merchant processes more than $1 million annually, even though the sub-merchant's application indicates processing volume will be less.
- The sub-merchant's business generates a lot of BBB complaints and the scrutiny of the FTC.
- The FTC sends you a CID asking for information and records about the sub-merchant.
- In reviewing information to respond to the CID, you discover that the sub-merchant may be processing transactions for other merchants that sell CBD.
- What do you do? Where can this lead?

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Example 3: Becoming the Direct Target of Law Enforcement

Hypothetical:

- You respond to a CID about one of your merchants that provides tech support services and provide the FTC with the underwriting file, merchant agreement, and processing data.
- Fortunately, you terminated this merchant for high chargebacks three months ago, but after two years of processing.
- And, as it turns out, this is the fourth CID you've responded to from the FTC in the last two years, and each one is about a merchant engaged in providing tech support services.
- About four months after responding to the latest CID, you get a new CID from the FTC. This time, instead of your customer, your company is the direct subject of the CID. The FTC wants to see your client list, examine your underwriting and risk management policies and practices, review company emails and documents, and interview your employees.
- What do you do? What might happen next?

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What Red Flags Does Law Enforcement Look For?

- Credit card laundering
- Making false statements to a bank to obtain payment processing services
- Failing to disclose to processing partners material information about a merchant account, such as:
  - Identity of any owner, manager, director, or officer of the applicant for or holder of a merchant account, and
  - Any connection between an owner, manager, director, or officer of the applicant and a person who was previously terminated (due to chargebacks, fraud, questionable merchant status, merchant collusion, illegal transactions, or identity theft.
- Using a shell company and nominee owners to apply for a merchant account
- Using tactics to avoid fraud and risk monitoring programs:
  - Load balancing sales transaction volume among multiple merchant accounts or merchant billing descriptors; or
  - Splitting a single sales transaction into multiple smaller transactions.

Examples of Recent Enforcement Actions

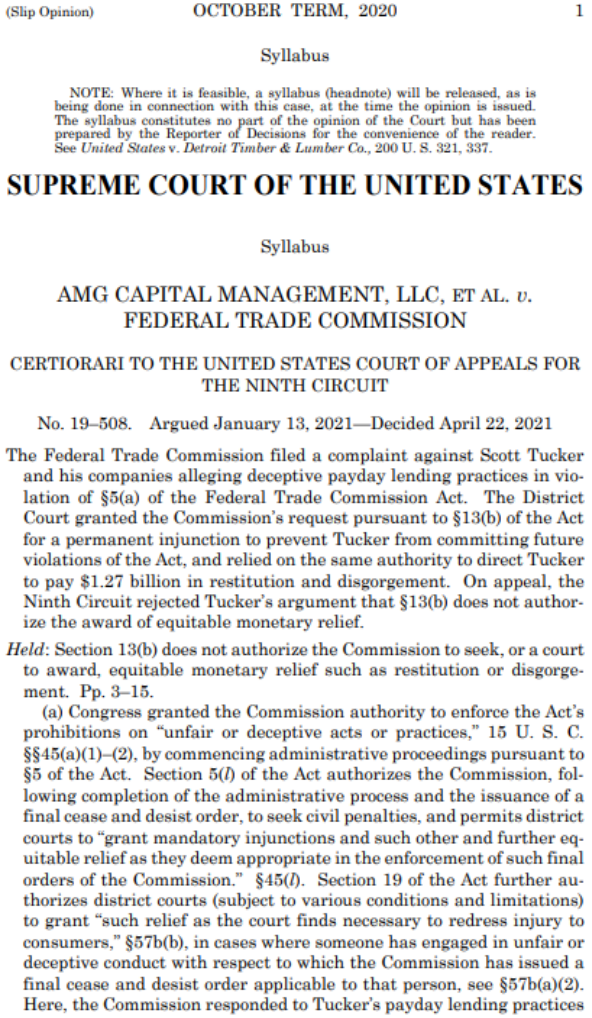
- BrightSpeed Solutions (CFPB, March 2021)
  - CFPB filed lawsuit in federal court against BrightSpeed and its founder and former CEO for knowingly processing remotely created check (RCC) payments for companies engaged in internet-based technical support fraud. CFPB alleged that between 2016 and 2018, BrightSpeed knowingly processed payments for client companies that purported to offer technical support services and products over the internet, but instead tricked consumers, often older Americans, into purchasing expensive and unnecessary antivirus software or services.
- Electronic Payment Solutions (FTC, Feb. 2021)
  - FTC permanently banned EPS and certain individuals from payment processing and telemarketing. Defendants assisted a deceptive business opportunities scheme known as Money Now Funding to obtain and maintain merchant accounts that allowed the operation to process almost $6 million through the credit card networks.
- Complete Merchant Solutions (FTC, December 2020)
  - FTC alleged that CMS illegally processed millions of dollars in consumer credit card payments for fraudulent schemes when they knew or should have known that the schemes were defrauding consumers. The FTC alleges that CMS ignored clear red flags of illegal conduct by those schemes, such as high rates of consumer chargebacks, use of multiple merchant accounts to artificially reduce chargeback rates so as to evade detection by banks and the credit card associations, submission of sham chargeback reduction plans, and the use of merchant accounts to process payments for products and services for which the merchant did not get approval from the bank holding the accounts.

News Flash: Supreme Court Takes Away One of the FTC's Weapons (for now)

AMG Capital Management, LLC v. FTC, 593 U.S. ____, 2021 WL 1566607

- Section 13(b) of the FTC Act – which is used to file lawsuits against processors and others for violating Section 5 of the FTC Act, which prohibits unfair or deceptive practices –

1. May only be used when the FTC reasonably believes a defendant "***is violating or is about to violate***" any provision of law enforced by the FTC.
2. Does not authorize the FTC to obtain monetary relief.



(Slip Opinion) OCTOBER TERM, 2020 1

Syllabus

NOTE: Where it is feasible, a syllabus (headnote) will be released, as is being done in connection with this case, at the time the opinion is issued. The syllabus constitutes no part of the opinion of the Court but has been prepared by the Reporter of Decisions for the convenience of the reader. See *United States* v. *Detroit Timber & Lumber Co.*, 200 U. S. 321, 337.

SUPREME COURT OF THE UNITED STATES

Syllabus

AMG CAPITAL MANAGEMENT, LLC, ET AL. *v.*
FEDERAL TRADE COMMISSION

CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

No. 19–508. Argued January 13, 2021—Decided April 22, 2021

The Federal Trade Commission filed a complaint against Scott Tucker and his companies alleging deceptive payday lending practices in violation of §5(a) of the Federal Trade Commission Act. The District Court granted the Commission's request pursuant to §13(b) of the Act for a permanent injunction to prevent Tucker from committing future violations of the Act, and relied on the same authority to direct Tucker to pay $1.27 billion in restitution and disgorgement. On appeal, the Ninth Circuit rejected Tucker's argument that §13(b) does not authorize the award of equitable monetary relief.

Held: Section 13(b) does not authorize the Commission to seek, or a court to award, equitable monetary relief such as restitution or disgorgement. Pp. 3–15.

(a) Congress granted the Commission authority to enforce the Act's prohibitions on "unfair or deceptive acts or practices," 15 U. S. C. §§45(a)(1)–(2), by commencing administrative proceedings pursuant to §5 of the Act. Section 5(*l*) of the Act authorizes the Commission, following completion of the administrative process and the issuance of a final cease and desist order, to seek civil penalties, and permits district courts to "grant mandatory injunctions and such other and further equitable relief as they deem appropriate in the enforcement of such final orders of the Commission." §45(*l*). Section 19 of the Act further authorizes district courts (subject to various conditions and limitations) to grant "such relief as the court finds necessary to redress injury to consumers," §57b(b), in cases where someone has engaged in unfair or deceptive conduct with respect to which the Commission has issued a final cease and desist order applicable to that person, see §57b(a)(2). Here, the Commission responded to Tucker's payday lending practices

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Post-*AMG Capital*

- FTC could bring more cases in administrative litigation obtaining cease and desist orders.
- FTC could refer more cases involving alleged wrongful conduct in the consumer financial space to the CFPB or to the Department of Justice.
- Section 19 of the FTC Act authorizes the FTC to go directly to federal court to obtain restitution and redress for violations of rules enforced by the FTC (such as the Telemarketing Sales Rule) and some statutes (such as the Restore Online Shoppers Confidence Act).
- Likely legislation with "fix" the FTC's 13(b) problem and restore the FTC's ability to pursue past conduct and obtain monetary damages.

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Spotlight on Select High Risk Industries

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Tech Repair

- FTC is focused on companies that purport to offer technical support services and products over the internet, but instead trick consumers, often older Americans, into purchasing expensive and unnecessary antivirus software or services.
  - CFPB v. BrightSpeed
  - FTC v. Elite IT Partners
- According to FTC, these merchants may engage in the following activities:
  - May use Internet ads targeting consumers looking for help to recover their email passwords.
  - May claim to be associated with well-known companies like Microsoft and Yahoo! and pressure consumers to provide access to their computers.
  - May run bogus "diagnostic" tests and warn that consumers' computers and personal information were in imminent danger. https://www.consumer.ftc.gov/scams/tech-support-scams

Mobile Gaming

Office of Commissioner
Rohit Chopra

UNITED STATES OF AMERICA
Federal Trade Commission
WASHINGTON, D.C. 20580

STATEMENT OF COMMISSIONER ROHIT CHOPRA
JOINED BY COMMISSIONER REBECCA KELLY SLAUGHTER

In the Matter of Tapjoy, Inc.
Commission File No. 1723092

January 7, 2021

Summary

- The explosive growth of mobile gaming has led to mounting concerns about harmful practices, including unlawful surveillance, dark patterns, and facilitation of fraud.
- Tapjoy's failure to properly police its mobile gaming advertising platform cheated developers and gamers out of promised compensation and rewards.
- The Commission must closely scrutinize today's gaming gatekeepers, including app stores and advertising middlemen, to prevent harm to developers and gamers.

The video game business has solidified its place as a fixture of America's entertainment industry. During the pandemic, revenues in the sector have reportedly eclipsed those of the sports and film businesses combined.[1] This period has brought about a massive increase in mobile gaming app installs and spending, cementing gaming as a major magnet for Americans' attention.[2] The latest industry offerings rely on deeper social connectivity features and facilitate content creation by players. Americans are hosting birthday parties through gaming apps, and tens of millions have attended concerts by major artists on Fortnite and Roblox.[3]

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COVID-related Products and Services

- Department of Justice
  - Since 2020, DOJ has filed dozens of enforcement actions against merchants engaged in COVID-19 fraud, such as websites that were unlawfully selling COVID-19 vaccine kits.
- Federal Trade Commission
  - Hundreds of warnings were issued to marketers nationwide to stop making unsubstantiated claims that their products and therapies can treat or prevent COVID-19.
- CFPB
  - Acting CFPB Director has identified COVID-19 financial relief for consumers a top priority. Similarly, Rohit Chopra, nominee for Director, has indicated the CFPB will continue to focus on consumers struggling during COVID-19.

Recurring Billing/Subscriptions

- During the pandemic, there is an increased reliance on recurring and subscription programs by consumers. This is an area that is subject to various federal and state laws.
- Federal Law
  - Telemarketing Sales Rule (phone only)
  - Restore Online Shoppers Confidence Act (ROSCA) (Internet only)
  - Section 5 of the FTC Act (all channels) (prohibits unfair and deceptive marketing practices)
- State Law
  - Automatic renewal laws in California, Virginia, Vermont, D.C., other states
  - State notification laws (renewal notices)
  - “Mini FTC Acts”
  - Multistate activity and class action risks

Cryptocurrency

- Companies involved in buying, selling, and/or exchanging cryptocurrency are likely money services businesses (MSBs). Some states have implemented cryptocurrency-specific licensing requirements.
- Higher risk and require additional diligence
  - FTC and CFPB have warned consumers about the risks of investing in cryptocurrencies.
  - FTC and FinCEN have issued warning that fraudsters may seek payment in cryptocurrency in connection with ransomware and other malicious computer attacks.
- Diligence should focus on type of service being sold, customer base, licensing, and internal policies and procedures.
  - Card Networks have certain specific requirements related to diligence and onboarding of cryptocurrency merchants.
  - Consider what type of red flags will be monitored for once a merchant is boarded.

CBD

- The legality of CBD is complicated, with the product sitting at the intersection of numerous federal and state laws.
  - According to the FDA, a dietary supplement, food or drug containing CBD (derived from hemp or marijuana) violates federal law, unless the FDA has specifically approved an application or regulation authorizing the marketing of such product.
  - In contrast, a ***cosmetic*** containing CBD may not violate the FDCA, as long as the CBD does not render the product injurious to users.
- For merchants, marketing hemp and CBD to consumers, there are also numerous federal (as well as state) laws that prohibit unfair or deceptive advertising and marketing practices, such as making false or unsubstantiated claims about the benefits of CBD.
- The FDA and FTC have warned purveyors of CBD oil that any claims that their product can prevent, treat, or cure human disease are required to be backed by reliable scientific evidence.

Cannabis

- Remains unlawful under federal Controlled Substances Act (CSA)
- Majority of states have legalized marijuana in some form (medicinal and/or recreational), with several states legalizing recreational usage in 2020 election
- There continue to be limits on processing for marijuana sales (network rules, etc.), and many sales remain cash based.
- Some companies are exploring non-cash payments
  - Gift cards/closed loop payments
  - Cryptocurrency
  - ATM
- What will happen if Congress passes legislation legalizing marijuana or providing a safe harbor for financial institutions?

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Adult

- Recent media scrutiny of adult entertainment industry and role of payments companies.
- Earlier this year, Mastercard updated rules for providing processing for adult content pursuant to its Specialty Merchant Registration program.
- Banks that connect merchants to the network will need to certify that the seller of adult content has effective controls in place to monitor, block and, where necessary, take down all illegal content.
- Other updated requirements include:
  - Documented age and identity verification for all people depicted and those uploading the content;
  - Content review process prior to publication;
  - Complaint resolution process that addresses illegal or nonconsensual content within seven business days; and
  - Appeals process allowing for any person depicted to request their content be removed.

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Multilevel Marketing

- MLMs are heavily scrutinized by federal and state regulators and private plaintiffs as potentially using unlawful pyramid schemes and other unfair or deceptive acts or practices.
  - MLMs are a form of direct selling (as opposed to retail) through a network of independent contractors, where existing members of the sales force typically recruit new members. This creates multiple levels of "distributors" or "participants" organized in "downlines," where a participant's downline consists of her network of recruits, and their recruits, and so on.
  - Two broad categories of risk: representations about the underlying product (e.g., dietary supplements) and representations about the business opportunity (i.e., participating in the MLM). Earnings claims typify the latter category, such as claims that participants can earn enough to quit their jobs and obtain expensive homes, luxury cars, and exotic vacations.
- FTC has brought enforcement actions in recent years against payment processors that assisted and facilitated the deceptive practices of MLMs, including against Allied Wallet (2019) and Qualpay (2020).
- Many states regulate "pyramid schemes" or "endless chain schemes" and prohibit the payment of money by the participant for the right to recruit others for economic gain where the compensation to the participant is unrelated to the sale of products or services.

What Do the Regulators Expect?

Sales Agent Underwriting and Monitoring

- Scrutinize: Are they complying with onboarding policies?
- *See* FTC v. First Data (2020 Settlement) – imposed wholesale ISO oversight program:
  - Methodology for assessing risk levels of each ISO;
  - Policies and procedures for overseeing the wholesale ISO's underwriting, monitoring, investigation, and adverse action as determined by the relevant risk rating;
  - Routine reviews of chargebacks, intensive "shadow monitoring" and post-onboarding of a sampling of new restricted merchant applications, review;
  - Monthly risk review of each wholesale ISO; and,
  - Approval of all new restricted merchant marketing materials.
- Terminate bad sales reps, and watch for one that try to re-enter the system.

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Merchant Underwriting and Monitoring

- Look for red flags:
  - Evidence of shell companies, nominee owners, multiple accounts, incomplete merchant applications, questionable information in application, evidence of past law enforcement activity (including of involved individuals), deficient sales and cancellation policies, and problematic marketing practices.
- Once processing, re-underwrite frequently to spot changes. Look for: splitting transactions, load balancing, “cascading” through multiple accounts to resubmit declined transactions.
- Monitoring processing volume, in addition to chargebacks and returns.
- Terminate, if necessary; report to MATCH list and other industry alerts as required.

Revisit Merchant Agreements

- Termination and suspension of service
  - When is the merchant in default?
  - Financial remedies?
- Key concepts: How do you define them? What are the remedies?
  - “Dishonest Activity”
  - “Improper Transactions”
  - “Excessive Processing”
- How might you avoid breach of contract claims from a merchant if you want to terminate them, freeze funds, etc.?

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Questions?

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