



BANKING REPORT



Internet Gambling Rules Would Enlist Banks to Fight Uphill Battle

By AMY G. RUDNICK & ANTHONY J. MAHAJAN

The U.S. Department of Justice consistently has taken the position that the interstate transmission of bets and wagers, via the telephone, Internet or otherwise, violates federal law.¹ That stance, however, failed to curb the explosive growth of online gaming in the United States, which, by some estimates, had swelled to a \$6 billion industry in 2005.² In response, virtual gambling businesses stationed their operations in other jurisdictions where Internet gaming is legal,³ and U.S. gamblers began funneling money to those locations using a variety of mechanisms, which have evolved over time. Initially, credit cards were used to fund gambling accounts, but once issuing banks began blocking authorizations, automated clearing house ("ACH") transactions became the predominant source of funding. U.S. gamblers also funded wagers via wire transfers, checks and money transmitting businesses

such as PayPal, Inc., and NETeller plc.⁴ Many of these same payment systems were used by gambling operators, less commonly, of course, to transmit gambling winnings to U.S. residents.

It was not until September 30, 2006, that Congress, finding traditional law enforcement mechanisms "inadequate" to combat online gambling, passed the Unlawful Internet Gambling Enforcement Act of 2006 ("UI-GEA" or "Act").⁵ That Act established criminal penalties for persons engaged in the business of betting or

¹ See The Wire Act, 18 U.S.C. § 1084 (1961); The Travel Act, 18 U.S.C. § 1952 (1961); and 18 U.S.C. § 1955 (1970) which prohibits operating a gambling business in violation of state law. In *United States v. Cohen*, 260 F.3d 68, 76 (2d Cir. 2001), the Second Circuit rejected the argument that the Wire Act "is too unclear to provide fair warning of what conduct it prohibits," and upheld the defendant's conviction based on his receipt of sports bets over the telephone and Internet.

² Dominic Walsh, *Gambling Online Faces Collapse in US After Senate Ban*, Times Online, Oct. 2, 2006, (http://business.timesonline.co.uk/tol/business/markets/united_states/article657249.ece.)

³ Traditional hotbeds for legalized Internet gambling activity include Costa Rica and the United Kingdom. Costa Rica has long catered to gambling operators, particularly sports bookmakers, and certain gambling operators targeted by U.S. prosecutors, including PartyGaming plc and 888 Holdings plc, are public companies trading on the London Stock Exchange.

⁴ On or about August 21, 2002, PayPal entered a settlement with the New York Attorney General's Office requiring it to cease processing payments for online gambling merchants and pay \$200,000 in disgorged profits, penalties and costs. See Press Release, Attorney General of the State of New York, Campaign Against Illegal Gambling Web Sites in New York Continues: Agreement Reached with PayPal to Bar New Yorkers from Online Gambling (Aug. 21, 2002), (http://www.oag.state.ny.us/press/2002/aug/aug21a_02.html). PayPal entered a second settlement, on or about July 24, 2003, with the U.S. Attorney for the Eastern District of Missouri, relating to charges that it aided illegal online gambling activities, and agreed to forfeit \$10 million in proceeds. See Press Release, United States Attorney, Southern District of New York, U.S. Charges Two Founders of Payment Services Company with Laundering Billions of Dollars of Internet Gambling Proceeds, (Jan. 16, 2007), (<http://www.usdoj.gov/usao/nys/pressreleases/January07/netellerarrestspr.pdf>). NETeller, however, continued to serve the U.S. online gambling market until mid-January 2007, when its founders, Stephen Lawrence and John Lefebvre, were arrested. See *id.* NETeller has since admitted that it violated U.S. law by transferring funds to and from Internet gambling operators located outside the United States; its founders have pled guilty to one count of conspiracy to use the wires to, *inter alia*, conduct illegal gambling businesses and face five-year prison terms. See Press Release, United States Attorney, Southern District of New York, Isle of Man-Based Internet Payment Company NETeller plc Admits Criminal Wrongdoing and Agrees to Forfeit \$136 Million for Conspiring to Promote Internet Gambling Business, (July 18, 2007), (<http://www.usdoj.gov/usao/nys/pressreleases/July07/Neteller%20DPA%20PR.pdf>.)

⁵ 31 U.S.C. § 5361 *et seq.* (2006).

Amy Rudnick is a partner in the Washington, D.C., office of Gibson, Dunn & Crutcher LLP. Anthony Mahajan is an associate resident in Gibson Dunn's New York office.

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wagering who knowingly accept payments to fund unlawful Internet gambling (“restricted transactions”) and civil remedies to prevent or restrain any person from engaging in restricted transactions.⁶ The Department of the Treasury (“Treasury”) and the Board of Governors of the Federal Reserve System (“Federal Reserve”) (together the “Agencies”) were required to prescribe – within 270 days of October 13, 2006, the Act’s enactment date – implementing regulations specifying, *inter alia*, precisely which “payment systems” would be “designated” for coverage under the statute and which participants in those systems would be required to establish policies and procedures to identify and block or otherwise prevent or prohibit restricted transactions.⁷ Accordingly, on October 1, 2007, the Agencies promulgated for public comment a notice of joint proposed rulemaking,⁸ intended to discharge the Agencies’ statutory obligations insofar as it: (1) “designates certain payment systems that could be used in connection with unlawful Internet gambling transactions;” (2) “exempts certain participants in designated payment systems from the requirements to establish policies and procedures;” and (3) “describes the types of policies and procedures that non-exempt participants in each type of designated payment system” are required to adopt.⁹ Comments on the Proposed Regulations, including whether the regulations as proposed are “reasonably practical,” were required to be submitted by December 12, 2007.

Notwithstanding the Agencies’ efforts to craft a “reasonably practical” rule, many aspects of the Proposed Regulations seem impractical, costly and unduly burdensome . . .

As required by the Act, the Agencies considered some of the practical difficulties in identifying and blocking restricted payments. They also considered whether the benefits of certain aspects of the Proposed Regulations would outweigh the associated costs. Consequently, while the proposed rulemaking covers *all* traditional payment systems – ACH systems, card systems, check collection systems, money transmitting businesses, and wire transfer systems – it provides *exemptions* for certain participants in ACH, check collection and wire transfer systems. Many of these exemptions are premised on the Agencies’ view that the primary responsibility for identifying and blocking domestic transactions should rest with the participants

⁶ *Id.* §§ 5362(7); 5363; 5365; 5366.

⁷ *Id.* § 5364(a).

⁸ See Prohibition on Funding of Unlawful Internet Gambling, 72 Fed. Reg. 56680 (Oct. 4, 2007). The Federal Reserve’s regulation is to be codified at 12 C.F.R. part 233 (cited hereinafter as “Proposed Regulation GG”), and Treasury’s proposed rule will be codified at 31 C.F.R. part 132. Proposed Regulation GG and the proposed Treasury regulation are identical and are referred to collectively in this article as the “Proposed Regulations.”

⁹ 72 Fed. Reg. at 56680-81; Proposed Regulation GG § 233.1(b).

that maintain the customer relationships with the Internet gambling businesses or, in the case of cross-border transactions, with the U.S. participants that provide correspondent accounts to the foreign banks used by Internet gambling businesses.

Notwithstanding the Agencies’ efforts to craft a “reasonably practical” rule, many aspects of the Proposed Regulations seem impractical, costly and unduly burdensome, particularly as they relate to (i) non-exempt participants in ACH, check collection and wire transfer cross-border transactions, (ii) the customer due diligence required of all non-exempt participants, and (iii) the transaction monitoring required for participants in money transmitting businesses and credit card systems. Moreover, the timeframe for implementation, *i.e.*, six months after the final regulations, may be insufficient to modify and implement new policies and procedures and to make any systems and software changes necessary to comply with the final rule.

Policies, Procedures Required of Non-Exempt “Designated Payment System” Participants

Section 5364 of the UIGEA requires “*each designated payment system, and all participants therein, to identify and block or otherwise prevent or prohibit restricted transactions through the establishment of policies and procedures reasonably designed to identify and block or otherwise prevent or prohibit the acceptance of restricted transactions.*”¹⁰ The UIGEA left it to the Agencies to prescribe regulations identifying the specific payment systems that “could be utilized in connection with, or to facilitate, any restricted transaction.”¹¹

The Proposed Regulations designate a broad range of payment systems: (1) “ACH systems;” (2) “Card systems;” (3) “Check collection systems;” (4) “Money

¹⁰ 31 U.S.C. § 5364(a) (emphasis added).

¹¹ *Id.* § 5362(3). In contrast, Section 5363, which bars various forms of funding to persons “engaged in the business of betting or wagering,” took effect immediately, leading prominent Internet gaming operators such as PartyGaming plc and 888 Holdings plc to announce their impending exit from the U.S. market once Congress passed the Act, though both companies have since disclosed “discussions” with the DOJ. See Press Release, PartyGaming plc, United States Legislation, (Oct. 2, 2006), (http://www.partygaming.com/images/docs/061001_USLegislation2.pdf); *id.* Discussions with the US Department of Justice, (June 4, 2007), (http://www.partygaming.com/images/docs/070406_Discussions_with_DoJ.pdf); Press Release, 888 Holdings plc, Announcement Re: US Legislation, (Oct. 2, 2006), (http://miranda.hemscott.com/servlet/HsPublic?context=ir.access&ir_option=RNS_NEWS&item=36483599715355&ir_client_id=5118&transform=newsitem); *id.* Discussions with the US Department of Justice, (June 5, 2007), (http://miranda.hemscott.com/servlet/HsPublic?context=ir.access&ir_option=RNS_NEWS&item=44770739273139&ir_client_id=5118&transform=newsitem). The Proposed Regulations, however, further make clear that liability under Section 5363 generally does not extend to financial transaction providers except in limited circumstances pursuant to Section 5367. Compare Proposed Regulation GG, § 233.2(r) (providing that a “person engaged in the business of betting or wagering” does not “include the activities of a financial transaction provider”) and 31 U.S.C. § 5362 (same), with 31 U.S.C. § 5367 (enumerating limited circumstances in which financial transaction provider may be held criminally liable).

transmitting businesses;” and (5) “Wire transfer systems.”¹² “Participants” in these systems would include “an operator of a designated payment system, or a financial transaction provider that is a member of or, has contracted for financial transaction services with, or is otherwise participating in, a designated payment system.”¹³ Non-exempt participants would be required to “establish and implement written policies and procedures reasonably designed to identify and block or otherwise prevent or prohibit restricted transactions.”¹⁴ End-user customers of a financial transaction provider are not included in the proposed definition of “participant,” unless the customer itself is a financial transaction provider that participates in the designated payment system on its own behalf.¹⁵

The lack of a clear definition of what constitutes unlawful Internet gambling would create a challenge for non-exempt participants who would be charged with determining whether a particular transaction violates federal law or the laws of any of the 50 states

A payment only would constitute a “restricted transaction” if it were made “in connection with the participation of another person in *unlawful* Internet gambling.”¹⁶ “Unlawful Internet gambling,” however, is defined only in loose terms under the Act (and repeated in the Proposed Regulations): “to place, receive or otherwise knowingly transmit a bet or wager by any means which involves the use, at least in part, of the Internet where such bet or wager is unlawful *under any applicable Federal or State law in the State or Tribal lands in which the bet or wager is initiated, received or otherwise made.*”¹⁷

The lack of a clear definition of what constitutes unlawful Internet gambling would create a challenge for non-exempt participants who would be charged with determining whether a particular transaction violates federal law or the laws of any of the 50 states, the District of Columbia, the U.S. commonwealths, territories and possessions, and the tribal lands. Such an undertaking would require significant research and legal

¹² Proposed Regulation GG, § 233.3. The designated payment systems are defined at Section 233.2(a) (“Automated clearing house system”); 233.2(d) (“Card system”); 233.2(f) (“Check collection system”); 233.2(p) (“Money transmitting business”); and 233.2(u) (“Wire transfer system”).

¹³ *Id.* § 233.2(q); see also *id.* § 233.2(k) (defining “Financial transaction provider”); 233.2(j) (defining “Financial institution”).

¹⁴ *Id.* § 233.5(a).

¹⁵ 72 Fed. Reg. at 56683.

¹⁶ 31 U.S.C. §§ 5362(7); 5363 (emphasis added); Proposed Regulation GG, § 233.2(r).

¹⁷ 31 U.S.C. § 5362(10) (emphasis added); Proposed Regulation GG, § 233(t) (emphasis added). Such gambling excludes “intrastate transactions,” “intra-tribal transactions” and “interstate horseracing.” *Id.*

analysis, particularly because the federal statutes generally prohibit operating an Internet gambling business or placing bets or wagers only if the activity violates state law.¹⁸ For instance, certain state laws may not prohibit specifically Internet gambling, while others may prohibit Internet gambling but may not prohibit all types of Internet gambling, e.g., gambling involving games of skill.¹⁹

Compounding this dilemma, the Agencies considered, but decided not to create, a list of unlawful Internet gambling businesses. According to the Agencies, this would require *them* to “interpret the various Federal and State gambling laws in order to determine whether the activities of each business that appears to conduct some type of gambling-related function are unlawful.”²⁰ As the Agencies correctly point out, this analysis would be complicated by the fact that the legality of a particular Internet gambling transaction might depend on the location of the gambler and/or the recipient, and by the fact that a business that engages in unlawful Internet gambling also might engage in lawful activities that are not prohibited by the Act.²¹ Even if the Agencies were to develop a list, the Agencies acknowledge that it would be difficult to maintain an updated list because Internet gambling businesses “can change the names they use to receive payments with relative ease and speed.”²² The Agencies’ concerns, of course, would be even more problematic for the participants, who would have less access to information about possible unlawful Internet gaming businesses and who unilaterally would bear the onus “to identify and block or otherwise prevent or prohibit restricted transactions.”²³

Given this uncertainty, payment system participants likely will find it inefficient to scrutinize each gaming-related payment to evaluate whether the particular payment is permitted under specific exceptions to the Act or otherwise constitutes “unlawful” Internet gaming. Consequently, as a practical matter, it is possible that non-exempt participants will adopt policies designed to

¹⁸ See, *supra*, n.1.

¹⁹ For instance, notwithstanding the government’s view that the UIGEA bars payments involving online poker and other games of skill, there is some debate in the Internet gaming industry whether the UIGEA bars payment transactions involving online poker and other gaming activity, in part because the Wire Act refers specifically to using wire communication facilities to transmit bets or wagers on “sporting events or contests.” Consequently, some gaming companies continue to accept poker wagers from U.S. residents even though they will not accept bets or wagers on sporting events. Congressman Wexler recently introduced the Skill Game Protection Act, which would exempt “games of skill” such as poker, chess and bridge from the UIGEA; the bill has been referred to the Committees on Financial Services, Energy and Commerce, and the Judiciary. See Skill Game Protection Act, H.R. 2610, 110th Cong.

²⁰ 72 Fed. Reg. at 56691.

²¹ *Id.* at 56692.

²² *Id.* at 56690-91. This was the case with NETeller which, according to its Deferred Prosecution Agreement, used two companies owned by its founders, JSL Systems Corp. and FCash Inc., to disguise ACH transfers and cash deposits in the United States. See NETeller plc – Deferred Prosecution Agreement, United States Attorney, Southern District of New York (July 17, 2007), at Exhibit C ¶ 12(a), (d), (http://content.neteller.com/file/NETELLER_DPA.pdf).

²³ 31 U.S.C. § 5364(a).

block all gaming-related payment activity, regardless whether such transactions are, in fact, illegal. The Act fosters this approach – notwithstanding the Agencies’ statutory obligation to “ensure that transactions in connection with any activity excluded from the definition of unlawful Internet gambling” are not blocked²⁴ – by providing that persons “shall not be liable to any party” for blocking or refusing to honor lawful transactions so long as they “reasonably believe” the transaction to be a “restricted transaction” or do so “in reliance on the policies and procedures of the payment system.”²⁵

That “[n]o designated payment system is completely exempted by the proposed rule,” might cause financial transaction participants to adopt policies and procedures as a precautionary matter.

Exemptions Proposed Only for ACH, Check Collection, Wire Transfer Systems

The Agencies, in their discretion, have determined that it would *not* be “reasonably practical” for “all participants” in designated payment systems to identify and block restricted transactions.²⁶ Accordingly, the Proposed Regulations exempt certain participants in the ACH, check collection and wire transfer systems. No exemptions are provided for participants in card systems and money transmitting businesses. While exempt participants in the ACH, check collection and wire transfer systems would not be required by law to establish policies and procedures to identify and block restricted transactions, the Agencies’ proposed approach is complex and the exemptions vary for domestic as opposed to cross-border transactions. That “[n]o designated payment system is completely exempted by the proposed rule,” might cause financial transaction participants to adopt policies and procedures as a precautionary matter.²⁷

Exemptions for Domestic Transactions

With respect to domestic transactions, all participants in ACH, check collection, and wire transfer systems would be exempt from the requirements of the Proposed Regulations except for those participants that possess the customer relationship with the Internet

gambling business.²⁸ Therefore, for domestic ACH transactions, only the originating depository financial institution (“ODFI”) in an ACH debit transaction, and the receiving depository financial institution (“RDFI”) in an ACH credit transaction, would be subject to the Act.²⁹ Similarly, all participants in the check collection system would be exempt except for the depository bank, *i.e.*, the first U.S. institution to which a check is transferred in a domestic check transaction, which would be the bank where the gambling business deposits the check.³⁰ Only the beneficiary’s bank in a domestic wire transfer transaction would be non-exempt.³¹ It is the Agencies’ view that each of these non-exempt participants has a relationship with its customer which would enable them, “with reasonable due diligence, [to] take steps to ascertain the nature of the customer’s business, [*i.e.*, to determine whether the customer is engaged in unlawful Internet gambling,] and ensure that the customer relationship is not used to receive restricted transactions.”³²

²⁸ See *id.* at 56685-86.

²⁹ The ACH system operator, the ODFI in an ACH credit transaction, and the RDFI in an ACH debit transaction all would be exempt with respect to domestic transactions. See *id.* at 56686. This is because neither the ACH system operator (whose function is to act as the central clearing facility for ACH entities) nor the RDFI in an ACH debit transaction has a direct relationship with the Internet gambling business or the opportunity to obtain information concerning restricted transactions prior to processing the transactions. See *id.* In addition, while the ODFI in an ACH credit transaction potentially could question the originator of the transfer, the Agencies presently are of the view that “any process requiring the customer to describe the nature of the transaction and/or state that the transaction does not involve unlawful Internet gambling may be of limited value, either because a customer may knowingly mischaracterize the actual nature of the transaction in order to avoid the transaction being rejected or blocked, or because the customer may not actually know whether an Internet gambling transaction is a restricted transaction under the Act.” *Id.*

³⁰ The check clearing house, paying bank and returning bank all would be exempted as they are intermediary parties that “generally do not have a direct relationship with either the payor or the payee in the check transaction and would not be in a position to obtain information from either party that would permit them to determine whether a particular check was a restricted transaction.” *Id.* at 56687. The paying bank, in contrast, generally would have a direct relationship with the gambler or gambling business, but nevertheless is exempted from the Act given the Agencies’ view that, primarily because of the automated nature of the check processing system, “it would not be in a position to obtain information from the payor prior to the transaction being settled,” including information pertaining to the payee. *Id.*

³¹ The operator of a wire transfer network, the originator’s bank and any intermediary bank would be exempted. See *id.* According to the Agencies, “[t]he information normally relied upon by intermediary banks’ automated systems in processing a wire transfer does not typically include information that would enable them to identify and block individual transfers as restricted transactions under the Act.” *Id.* In addition, while the originator’s bank may have some relationship with its customer, for many of the same reasons that the rule proposes to exempt the ODFI in an ACH credit transaction, the Agencies presently are of the view that the originating bank in a wire transfer transaction should not be required to take measures to identify restricted transactions because “any associated benefits would likely be outweighed by the associated costs.” *Id.*

³² *Id.* at 56686, 56687.

²⁴ *Id.* § 5364(b)(4). Proposed Regulation GG merely reiterates the Agencies’ view that “[n]othing in this regulation requires or is intended to suggest that designated payment systems or participants therein must or should block or otherwise prevent or prohibit any transaction in connection with any activity that is excluded from the definition of ‘unlawful Internet gambling.’” Proposed Regulation GG, § 233.5(d). The Agencies explain that they are not authorized under the Act to require payment systems or participants to process “those transactions excluded from the Act’s definition of unlawful Internet gambling, if a system or participant decides for business reasons not to process such transactions.” 72 Fed. Reg. at 56688.

²⁵ 31 U.S.C. § 5364(d)(2), (3).

²⁶ *Id.* § 5364(a).

²⁷ 72 Fed. Reg. at 56686.

Without a list of businesses involved in unlawful Internet gambling, however, this task would be daunting. Given the prohibition on conducting transactions involving unlawful Internet gambling, it is unlikely that, if asked, a business would disclose the true nature of its activities. This would place the burden on non-exempt participants to develop other measures to identify such businesses, which might include developing lists from publicly available sources or conducting Internet searches on every commercial customer. This likely would be burdensome, costly and of limited value, particularly because the names of Internet gambling businesses and related payment service providers may change, and because such businesses may obscure their true operations through the use of various corporate layers or affiliates.

Different Exemptions for Cross-Border Transactions

Unlike the broad exemptions for domestic transactions, the Proposed Regulations contain significant limitations to the exemptions for cross-border transactions. Because “most unlawful Internet gambling businesses do not have direct account relationships with U.S. financial institutions,” but rather accounts “at offshore locations of foreign institutions that are not subject to the Act,” these transactions likely will present the majority of restricted transactions and the greatest challenges.³³ Thus, heightened vigilance would be necessary for these transactions.

. . . this might place responsibility on the U.S. bank to conduct periodic Internet searches of its foreign correspondent banking clients to determine whether the foreign bank’s customers are involved in unlawful Internet gambling—a dubious undertaking at best.

With respect to incoming cross-border ACH and check collection transactions, “the first participant in the United States that receives the incoming transaction directly from a foreign institution (*i.e.*, an ACH debit transaction from a foreign gateway operator, foreign bank, or a foreign third-party processor or a check for collection directly from a foreign bank)” would be required to “take reasonable steps to ensure that their cross-border relationship is not used to facilitate restricted transactions,” including through the use of contractual provisions ensuring that the foreign institution has “policies and procedures in place to avoid sending restricted transactions to the U.S. participant,” and which contain recourse, such as termination of the relationship, in the event restricted transactions are discovered.³⁴

In the case of outgoing wire transfers and ACH credit transactions, “the originator’s bank or the intermediary bank in the U.S. that sends the wire transfer transac-

tion, or the gateway operator that sends the ACH credit entry, directly to a foreign bank should have policies and procedures in place to be followed if such transfers to a particular foreign bank are subsequently determined to be restricted transactions.”³⁵ By way of example, the Agencies note in the preamble to the Proposed Regulations (but not in the Proposed Regulations themselves) that some Internet gambling businesses identify the correspondent banks through which they receive wire transfers on their websites.³⁶ In such a case, the Agencies appear to be suggesting that the U.S. participant should consider whether to continue providing wire transfer services or maintaining a correspondent relationship with the foreign bank. If so, this might place responsibility on the U.S. bank to conduct periodic Internet searches of its foreign correspondent banking clients to determine whether the foreign bank’s customers are involved in unlawful Internet gambling – a dubious undertaking at best. Moreover, such a requirement would exceed the current enhanced due diligence requirements under the Bank Secrecy Act for foreign correspondent bank clients.³⁷

The Lack of Exemptions for Card Systems, Money Transmitting Businesses

The Proposed Regulations do not provide any exemptions to the participants in card systems and money transmitting businesses. According to the Agencies, card systems “have developed merchant category and transaction codes that identify the business line of the payee (*e.g.*, the gambling business) and how the transfer was initiated (such as via the Internet), so that the systems are able to identify and block certain types of payments in real time.”³⁸ The merchant category code associated with betting (7995), however, is broad and encompasses both lawful gaming activities, such as lottery tickets and off-track betting and wagers, as well as unlawful Internet gambling. The Agencies’ view also presupposes that Internet gambling businesses will disclose the true nature of their activities and that card systems will be able to identify those businesses that do not through reasonable due diligence measures.

In addition, the Agencies contend that “a customer can make payment by check, ACH or wire transfer to any business,” whereas transfers via card systems and money transmitting businesses may be made “only to those businesses that have explicitly agreed to participate in those payment systems.”³⁹ Again, this assumes that credit card merchants and commercial subscribers of money transmitting businesses will reveal the nature of their business or that the acquiring institutions or money transmittal businesses will be able to determine whether a merchant or commercial subscriber is an Internet gambling business.

Required Due Diligence, Remedial Measures, Monitoring and Testing

As proposed, all non-exempt participants in designated payment systems would be required to establish

³⁵ *Id.*

³⁶ *See id.*

³⁷ *See* Due Diligence Programs for Correspondent Accounts for Foreign Financial Institutions, 31 C.F.R. 103.176 (2006).

³⁸ 72 Fed. Reg. at 56685.

³⁹ *Id.* at 56685-86.

³³ *Id.* at 56689.

³⁴ *Id.* at 56690.

and implement written policies and procedures that are reasonably designed to identify and block or otherwise prevent or prohibit restricted transactions, including policies and procedures which “(i) [a]ddress methods for conducting due diligence in establishing or maintaining a commercial customer relationship designed to ensure that the commercial customer does not originate or receive restricted transactions through the customer relationship; and (ii) include procedures reasonably designed to prevent or prohibit restricted transactions, including procedures to be followed with respect to a customer if the participant discovers the customer has been engaging in restricted transactions through its customer relationship.”⁴⁰

Consistent with the Act, the Proposed Regulations permit a non-exempt “financial transaction provider” to rely on and comply with “the written policies and procedures of the designated payment system,” provided that those policies and procedures are reasonably designed to identify and block or otherwise prevent or prohibit restricted transactions and that they comply with the Agencies’ regulations.⁴¹ Thus, in order to “rely” on the payment system, a financial transaction provider would have to review and assess the reasonableness of the designated payment system’s policies and procedures to identify and block restricted transactions for compliance with the Proposed Regulations. Given the difficulties associated with evaluating the sufficiency of another’s internal policies and procedures and the fact that the Federal functional regulators for most of the designated payment systems have exclusive jurisdiction to make this assessment, non-exempt participants may conclude that it would be prudent to develop their own internal policies and procedures.⁴²

The Proposed Regulations also include the safe harbor provided in the Act which protects a person that identifies, blocks, prevents, prohibits or otherwise refuses to honor a transaction from liability to any party if (i) the transaction is a restricted transaction; (ii) the person reasonably believes that the transaction is a restricted transaction; or (iii) the person is a participant in a designated payment system and prevented the transaction in reliance on the designated payment system’s policies and procedures.⁴³

Due Diligence Procedures

The Agencies expect that participants “would use a flexible, risk-based approach in their due diligence procedures in that the level of due diligence performed would match the level of risk posed by the customer,”⁴⁴ with those procedures incorporated “into existing

account-opening due diligence procedures (such as those required of depository institutions under Federal banking agencies’ anti-money laundering compliance program requirements).”⁴⁵ Non-exclusive examples of reasonably designed due diligence procedures would include “[s]creening potential customers to ascertain the nature of their business” and “[i]ncluding as a term of the commercial agreement that the customer may not engage in restricted transactions.”⁴⁶

It is not clear, however, if screening contemplates screening the participant’s commercial customers against an available list of Internet gaming businesses or if it also encompasses conducting Internet or other searches on all commercial customers, which, as discussed above, may be unduly burdensome, costly and of limited utility. According to the Agencies, “first-in-line” participants in cross-border transactions also would be required to address due diligence of foreign counterparties, such as by requiring those entities to have appropriate policies and procedures in place to ensure that the relationship will not be used to process restricted transactions.⁴⁷

Remedial Measures

Non-exempt participants also would be required to establish policies and procedures to be followed if they were to become “aware” that one of their customers was being used to process restricted transactions.⁴⁸ These procedures could include different remedial options, including when fines should be imposed, when a customer’s access should be denied, and when the rela-

Agencies’ concern that “use of third-party senders in ACH transactions poses particular risks because the ODFI does not have a direct relationship with the originators.” *Id.* at 56683. Third-party senders, which act as intermediaries “between an originator and an ODFI with respect to the initiation of ACH transactions where there is no contractual agreement between the originator and the ODFI,” arguably do not fall within the definition of a payment system “participant” or “financial transaction provider.” *Id.*; Proposed Regulation GG, § 233.2(q), (k). Rather, the Proposed Regulations place the burden on “participants” to “conduct appropriate due diligence with respect to the third-party sender.” 72 Fed. Reg. at 56688. Nevertheless, third-party senders, while exempt from the Act, may face liability in other respects for activities related to unlawful Internet gambling, as demonstrated by the Electronic Clearing House, Inc. (“ECHO”) settlement. *See* Echo, Inc. – Non-Prosecution Agreement, United States Attorney, Southern District of New York, (March 26, 2007), (http://www.sec.gov/Archives/edgar/data/721773/000114036107009597/ex10_01.htm). ECHO admitted there that it had processed payments from U.S. residents to e-wallets, such as Firepay, Citadel and NETeller, through the ACH system, and agreed to forfeit \$2.3 million. *See id.* at 1, 3 & Exhibit A.

⁴⁵ 72 Fed. Reg. at 56688.

⁴⁶ Proposed Regulation GG, § 233.6(b)(1)(i); (c)(1); (d)(1)(i); (e)(1); (f)(1)(i). In addition, with respect to third-party ACH senders, “the participant should ensure that there is a process to monitor the operations of the third-party sender, such as by audit,” to confirm, at a minimum, that the third-party sender conducts “due diligence on its customers to ensure that it is not transmitting restricted transactions through an ODFI.” 72 Fed. Reg. at 56688-89.

⁴⁷ Proposed Regulation GG, § 233.6(b)(2)(i); (d)(2)(i).

⁴⁸ 72 Fed. Reg. at 56689. It is unclear what would constitute “awareness” and to what extent awareness differs from knowledge.

⁴⁰ *Id.* at 56688.

⁴¹ Proposed Regulation GG, § 233.5(b); *see also id.* § 233.2(k).

⁴² Exclusive regulatory enforcement of the requirements under the new regulations would rest with the Federal functional regulators of the designated payment systems and the participants in those systems, with residual jurisdiction left to the Federal Trade Commission (“FTC”) for designated payment systems and financial transaction providers not subject to the jurisdiction of any Federal functional regulator. *See id.* § 233.7. Notably, this would subject money transmitting businesses, for which there is no Federal functional regulator, to the jurisdiction of the FTC in matters traditionally handled by Treasury.

⁴³ *See id.* § 233.5(c).

⁴⁴ 72 Fed. Reg. at 56688. Notably, “third-party senders” appear to be exempt from the Proposed Regulations, despite the

tionship should be terminated or account closed.⁴⁹ According to the Agencies, “first-in-line” participants in cross-border transactions also would be expected to deny services to foreign banks or terminate the relationship altogether.⁵⁰ The Agencies make clear that nothing in the proposed rule would modify any existing legal requirement to file suspicious activity reports.⁵¹

Additional Monitoring, Testing Required of Card, Money Transmitting Participants

In addition to implementing due diligence and remedial measures, card system and money transmitting business participants would be required to conduct additional monitoring and testing to identify restricted transactions. These participants would be required to engage in “[o]ngoing monitoring or testing” to (1) “detect unauthorized use” of the relevant card system or money transmitting business, “including [the use of] their trademarks” on the Internet or otherwise; and (2) analyze “payment patterns to detect suspicious payment volumes” from a customer or to any recipient.⁵² It is not clear, however, how a participant could systematically identify the unauthorized use of its system or business by unlawful Internet gambling businesses or how effective monitoring systems can be in identifying restricted transactions. Card systems would be required to go further to the extent that they have not previously established “transaction codes and merchant/business codes that are required to accompany the authorization request” which “enable the card system or the card issuer” to deny authorization for restricted transactions, and conduct testing “to ascertain whether transaction authorization requests are coded correctly.”⁵³

Conclusion

The UIGEA passed with overwhelming legislative support, perhaps because it was tacked onto the long-awaited Security and Accountability for Every (“SAFE”) Port Act of 2006 hours before its enactment. Nevertheless, the UIGEA has a number of vocal opponents, most notably, Congressman Barney Frank, chairman of the House Financial Services Committee. He has sponsored legislation that would establish a federal licensing and tax regime for the conduct of legalized Internet gambling in the United States.⁵⁴ Proponents of the proposed legislation contend that such a scheme is necessary because, notwithstanding government efforts to combat Internet gambling, the practice continues largely unchecked, the companies that “are facilitating the wagers are less reputable, and there are less avenues for recourse if a consumer is defrauded.”⁵⁵ They also argue that the UIGEA represents an intrusion by

the federal government on constitutionally protected rights.⁵⁶

Many of these same concerns, however, were previously voiced in opposition to the enactment of the UIGEA and rejected.⁵⁷ Currently, the proposed legislation lacks traction and faces significant opposition.⁵⁸ As it presently stands, in the United States, Internet gambling is illegal; it has long been considered illegal (even prior to the UIGEA); and U.S. prosecutors have exhibited a renewed zeal for enforcement of the laws in this area.⁵⁹

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Some would argue that the UIGEA foists responsibility upon U.S. financial institutions and payments systems to address indirectly societal ills associated with Internet gambling. These societal ills were raised by Congress when it passed the Act: (i) ever-increasing numbers of underage persons gambling online; (ii) compulsive gambling addictions resulting in unmanageable levels of consumer debt; (iii) various criminal elements traditionally infiltrating gambling operations; and (iv) heightened risks of consumer fraud in the context of an unregulated online gambling environment.⁶⁰

⁵⁶ See *id.* at 42, 47. Interactive Media Entertainment and Gaming Association, a self-described non-profit association of members involved in Internet gambling, filed suit in the District of New Jersey on or about June 5, 2007, seeking a determination that the UIGEA is unconstitutional because it infringes protected rights to freedom of association, privacy and free speech. See *Interactive Media Entm't & Gaming Assoc., L.L.C., v. Gonzalez*, No. 07-2626 (D.N.J. 2007) (Cooper, J.).

⁵⁷ See *Internet Gambling Prohibition Act of 2006: Hearing on H.R. 477 Before the Subcomm. on Crime, Terrorism, and Homeland Security of the H. Comm. on the Judiciary*, 109th Cong. 2-4 (April 5, 2006) (statement of Congressman Scott).

⁵⁸ The National Association of Attorneys General, National Football League, Major League Baseball, National Basketball Association, National Hockey League and National Collegiate Athletic Association are among the entities that have opposed the proposed legislation. See *Hearing on H.R. 2046 Before the H. Comm. on Financial Services*, 110th Cong. 169-75.

⁵⁹ On or about May 11, 2007, BetUS.com and three corporate defendants, CurrenC, Ltd., Gateway Technologies, LLC, and Hill Financial Services, Inc., were indicted on charges that they, *inter alia*, duped banks and credit card companies into processing payments for illegal Internet gambling transactions. See Press Release, United States Attorney, District of Utah, Grand Jury Returns Indictment Charging Defendants With Operating Illegal Credit Card Transaction, Processing Business: Indictment Alleges Defendants Provided Services To Disguise Credit Card Charges For Internet Gambling, (May 11, 2007), (<http://www.usdoj.gov/tax/usaopress/2007/txdv07-5-11-Lombardo.pdf>).

⁶⁰ See, e.g., *Hearing on H.R. 2046 Before the H. Comm. on Financial Services*, 110th Cong. 3-6 (testimony of Congressman Bachus); 72 Fed. Reg. at 56691. “Banking and gaming

⁴⁹ Proposed Regulation GG, § 233.6(b)(1)(ii); (c)(3); (d)(1)(ii); (e)(3); (f)(1)(ii).

⁵⁰ See *id.* § 233.6(b)(2)(ii), (3); (d)(2)(ii); (f)(2).

⁵¹ See *id.* § 233.5(e).

⁵² *Id.* § 233.6(c)(2)(ii)(B), (C); (e)(2).

⁵³ *Id.* § 233.6(c)(2)(i), (ii)(A).

⁵⁴ See *Internet Gambling Regulation and Enforcement Act of 2007*, H.R. 2046, 110th Cong. (2007); *Internet Gambling Regulation and Tax Enforcement Act of 2007*, H.R. 2607, 110th Cong. (2007). The proposed legislation would permit states the ability to “opt-out” of the regulatory scheme.

⁵⁵ *Can Internet Gambling be Effectively Regulated to Protect Consumers and the Payments System?: Hearing on H.R. 2046 Before the H. Comm. on Financial Services*, 110th Cong. 33 (2007) (testimony of Radley Balko).

Because directly prosecuting the Internet gambling businesses and their principals posed jurisdictional difficulties, and traditional law enforcement mechanisms had proved “inadequate” for regulating Internet gam-

regulatory officials did not view Internet gambling as being particularly susceptible to money laundering.” United States General Accounting Office, *Internet Gambling: An Overview of the Issues*, Dec. 2002, GAO-03-89, at 37, (<http://www.gao.gov/new.items/d0389.pdf>).

bling at the federal or state level, the UIGEA seemed the most feasible plan of attack at the time. Moreover, it seems apparent that penalizing gamblers themselves would not effectively curb illegal online gambling any more than the prosecution of end-users has stemmed the drug trade. In other words, Congress did not have many viable options available to it in combating illegal Internet gambling. It remains to be seen, however, to what extent the Act successfully will remediate the underlying societal evils it was designed to address.