Internet Gambling

Agencies Promulgate Final Regulations on Internet Gambling

SUMMARY
On November 12, 2008, the U.S. Treasury Department and the Federal Reserve Board jointly promulgated final regulations implementing certain provisions of the Unlawful Internet Gambling Enforcement Act of 2006. The Act generally requires financial institutions and other payment processors to establish procedures designed to block Internet gambling-related financial transactions. The final regulations:

- Designate certain “payment systems” that fall within the Act’s scope because they could be used in connection with unlawful Internet gambling;
- Require participants in designated payment systems to establish policies and procedures to identify and block, or otherwise prevent or prohibit, transactions in connection with unlawful Internet gambling;
- Exempt certain participants in designated payment systems from these requirements; and
- Describe the types of policies and procedures that non-exempt participants in designated payment systems may adopt in order to comply with the Act and provide non-exclusive examples of such procedures.

The final regulations are effective January 19, 2009, and financial intermediaries subject to the Act must be in compliance by December 1, 2009.

BACKGROUND – REGULATION OF INTERNET GAMBLING
During the decade preceding the Act, various federal anti-gambling statutes were used in prosecutions of individuals affiliated with Internet gambling businesses. At the same time, Congress considered additional measures to address the specific challenges posed by electronic and Internet gambling, culminating in passage of the Act in 2006. In the Act, Congress sought to enlist financial intermediaries in policing Internet gambling by requiring them to take steps to block Internet gambling-related financial
transactions. The Act thus directed the U.S. Treasury Department and Federal Reserve Board (the “Agencies”) to promulgate regulations requiring financial intermediaries to establish policies and procedures reasonably designed to identify and block, or otherwise prevent or prohibit, “restricted transactions.” For more on the Act and background on federal regulation of Internet gambling, please see our October 13, 2006 memorandum entitled “Internet Gambling.”

On October 1, 2007, the Agencies promulgated proposed regulations pursuant to the Act. After considering extensive public comments, the Agencies promulgated final regulations on November 12, 2008.

THE FINAL REGULATIONS

Overview

The regulations identify five categories of payment systems that could be used to facilitate unlawful Internet gambling and require that certain participants in such systems establish and implement policies and procedures reasonably designed to identify and block, or otherwise prevent or prohibit, restricted transactions. As described more fully below, for four of the five categories of designated payment systems, the core policy and procedure that the regulations require is the implementation of a “flexible, risk-based” due diligence process in establishing and maintaining commercial customer relationships. The regulation thus places primary responsibility on the participants in those systems that have the direct relationships with Internet gambling businesses to conduct due diligence to determine the likelihood that customer relationships will be used to facilitate unlawful Internet gambling transactions.

The regulations do not define “unlawful Internet gambling” beyond the definition provided in the Act, but instead rely on existing federal and state law definitions of unlawful conduct.

Designated payment systems and their participants

The Act defines a “designated payment system” as any system used by a financial transaction provider that the Agencies jointly determine could be used in connection with, or to facilitate, any restricted

---

1 A “restricted transaction” generally is any transaction involving the knowing acceptance of credits, funds, investments, or proceeds by a person engaged in the business of betting or wagering in connection with unlawful Internet gambling.

2 The proposed regulations were discussed in our memorandum entitled “Internet Gambling” dated October 9, 2007.


4 Under the Act and regulations, “financial transaction providers” include a wide range of financial intermediaries.
transaction. In the regulations, the Agencies identify and define five types of “designated payment systems”: (1) automated clearing house (ACH) systems, (2) card systems, (3) check collection systems, (4) money transmitting businesses, and (5) wire transfer systems.

The regulations define a “participant” in a designated payment system to include an operator of such a system, a financial transaction provider that participates in such a system, or a third-party processor.

Exemptions for broad categories of participants
The regulations exempt many participants in four of the five categories of designated payment systems. In the case of ACH, check collection, and wire transfer systems, the regulations apply only to those participants that possess customer relationships with Internet gambling businesses and those engaged in certain cross-border transactions. In the case of money transmitting businesses, all participants other than operators are exempt.

Safe harbor policies and procedures
For each type of non-exempt designated payment system participant, the proposed regulations provide non-exclusive examples of customer due diligence and other compliance and monitoring policies and procedures that would be deemed to comply with the regulations.

5 The final regulation narrows the designation of money transmitting businesses in the proposed regulation. It thus (a) clarifies that “money transmitting businesses” do not encompass businesses that engage in check cashing, currency exchange, or issuance or redemption of money orders, travelers’ checks, or similar instruments; and (b) narrows the scope of the regulation to apply only to businesses that permit customers to initiate transactions remotely from locations other than a physical office of the money transmitting business.

6 An “operator” is an entity that provides “centralized clearing and delivery services” between participants “and maintains the operational framework for the system.” “Third party processors” were not expressly included in the proposed regulations, and were specified in the final regulations in response to comments suggesting that the regulation clarify the obligations of processors. The definition of “third party processors” encompasses only a processor with a direct customer relationship with either the originator of a debit transfer transaction or the receiver of a credit transfer transaction and who acts as intermediary between the originator/receiver and the depository institution.

7 Specifically, the depository financial institution receiving an ACH credit transaction or originating an ACH debit transaction, the depository bank in the case of a check collection transaction, or the beneficiary’s bank in the case of a wire transfer.

8 Specifically, the final regulation exempts participants in cross-border ACH, check collection, and wire transfer systems other than those receiving cross-border debit transactions, such as ACH debits or check collections, from a foreign sender. This is a significant narrowing of the scope of cross-border obligations provided in the proposed regulations. The regulations make no distinction between domestic and cross-border card system or money transmitting business transactions.

9 The proposed regulations had no exemptions for participants in money transmitting businesses. This exemption was adopted in the final regulation in response to comments suggesting that “send” agents should be exempt because they lack any direct relationship with the commercial customer receiving the funds.
The regulations provide a detailed description of the kind of “flexible, risk-based” due diligence in account opening and maintenance that the regulations contemplate:

- Participants should obtain a basic understanding of a new commercial customer’s business. If, based on that understanding, there exists only a minimal risk that the customer would use the customer relationship for Internet gambling transactions, then no further due diligence would be required.

- If the risk is more than minimal—such as a customer in the business of offering games over the Internet—then further documentation should be obtained from the customer, which could include the customer’s certification that it is not involved in Internet gambling business.

- If the prospective customer is involved in Internet gambling business, the participant may rely on either (a) proof that the customer has obtained a license authorizing the activity from the appropriate state or tribal authority or (b) a reasoned legal opinion from the prospective customer’s counsel demonstrating that the prospective customer’s Internet gambling business does not involve restricted transactions. The regulations also suggest obtaining third-party certification of the prospective customer’s systems for enforcing age and location verification to ensure that its Internet gambling business remains within licensed or otherwise lawful limits.10

- Participants should also notify all of their commercial customers, through provisions in account or commercial customer relationship agreements or otherwise, that restricted transactions are prohibited from being processed through the account or relationship.

This due diligence—which may be performed in combination with other customer due diligence required by the Bank Secrecy Act and other federal laws—is expected to form the primary policy and procedure for non-exempt participants in ACH, check collection, and wire transfer systems. Such due diligence is also contemplated for money transmitting businesses and remains an option for card systems. With respect to card systems, however, the regulations generally anticipate that, as an alternative to the “risk-based” due diligence framework, participants will develop or use existing transaction coding mechanisms to identify and block suspected unlawful Internet gambling transactions in real time.11

The regulations contemplate that non-exempt participants in all designated payment systems will implement policies and procedures to deny services to commercial customers actually known to have engaged in restricted transactions through the customer relationship. With respect to both card systems

---

10 The description of this “risk-based” due diligence—which was not included in the proposed regulations—is intended to “shift the burden of proof” of distinguishing lawful from unlawful Internet gambling activity to the Internet gambling business rather than the financial intermediary.

11 Non-operator participants in an “operator-driven” designated payment system such as a card system may rely on and comply with policies and procedures adopted by an operator, in which case they need not separately adopt their own policies and procedures. The participant need not independently verify compliance of the operator’s policies and procedures with the regulations, and may rely on the operator’s written notice to its participants that it has adopted policies and procedures to comply with the regulations, unless federal regulators have given notice that such policies and procedures are non-compliant.
and money transmitting businesses, the regulations contemplate additional procedures for monitoring or testing by the operator to detect potentially suspicious payment volumes to particular recipients.

With respect to non-exempt cross-border ACH, check collection, and wire transfer transactions, the final regulations contemplate that domestic financial intermediaries will adopt policies and procedures to be followed in the event that the intermediary receives actual knowledge through notification by a government entity that restricted transactions have occurred with a particular foreign sender, such as procedures to provide notice to the foreign sender. The regulations include a sample form of notice that may be used. As noted above, the regulations make no distinction between domestic and cross-border card system or money transmitting business transactions.

No liability for blocking transactions
No designated payment system participant can be liable for blocking a transaction if (1) the transaction is restricted, (2) the person reasonably believed it to be restricted, or (3) it was blocked pursuant to policies and procedures implemented in an effort to comply with the regulations pursuant to the Act.

Enforcement
Like the Act, the regulations are to be enforced by the “Federal functional regulators” (that is, the Federal banking regulators) or, for those entities that do not have a Federal functional regulator, by the Federal Trade Commission.

*   *   *
SULLIVAN & CROMWELL LLP

ABOUT SULLIVAN & CROMWELL LLP
Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance and corporate transactions, significant litigation and corporate investigations, and complex regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 700 lawyers on four continents, with four offices in the U.S., including its headquarters in New York, three offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP
This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers listed below, or to any other Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future related publications from Jennifer Rish (+1-212-558-3715; rishj@sullcrom.com) or Alison Alifano (+1-212-558-4896; alifanoa@sullcrom.com) in our New York office.

CONTACTS

<table>
<thead>
<tr>
<th>New York</th>
<th>New York</th>
<th>New York</th>
</tr>
</thead>
<tbody>
<tr>
<td>Elizabeth T. Davy</td>
<td>1-212-558-7257</td>
<td><a href="mailto:davye@sullcrom.com">davye@sullcrom.com</a></td>
</tr>
<tr>
<td>Steven R. Peikin</td>
<td>1-212-558-7228</td>
<td><a href="mailto:peikins@sullcrom.com">peikins@sullcrom.com</a></td>
</tr>
<tr>
<td>Karen Patton Seymour</td>
<td>1-212-558-3196</td>
<td><a href="mailto:seymourk@sullcrom.com">seymourk@sullcrom.com</a></td>
</tr>
<tr>
<td>Michael M. Wiseman</td>
<td>1-212-558-3846</td>
<td><a href="mailto:wisemanm@sullcrom.com">wisemanm@sullcrom.com</a></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Samuel R. Woodall III</td>
<td>1-202-956-7584</td>
<td><a href="mailto:woodalls@sullcrom.com">woodalls@sullcrom.com</a></td>
</tr>
</tbody>
</table>