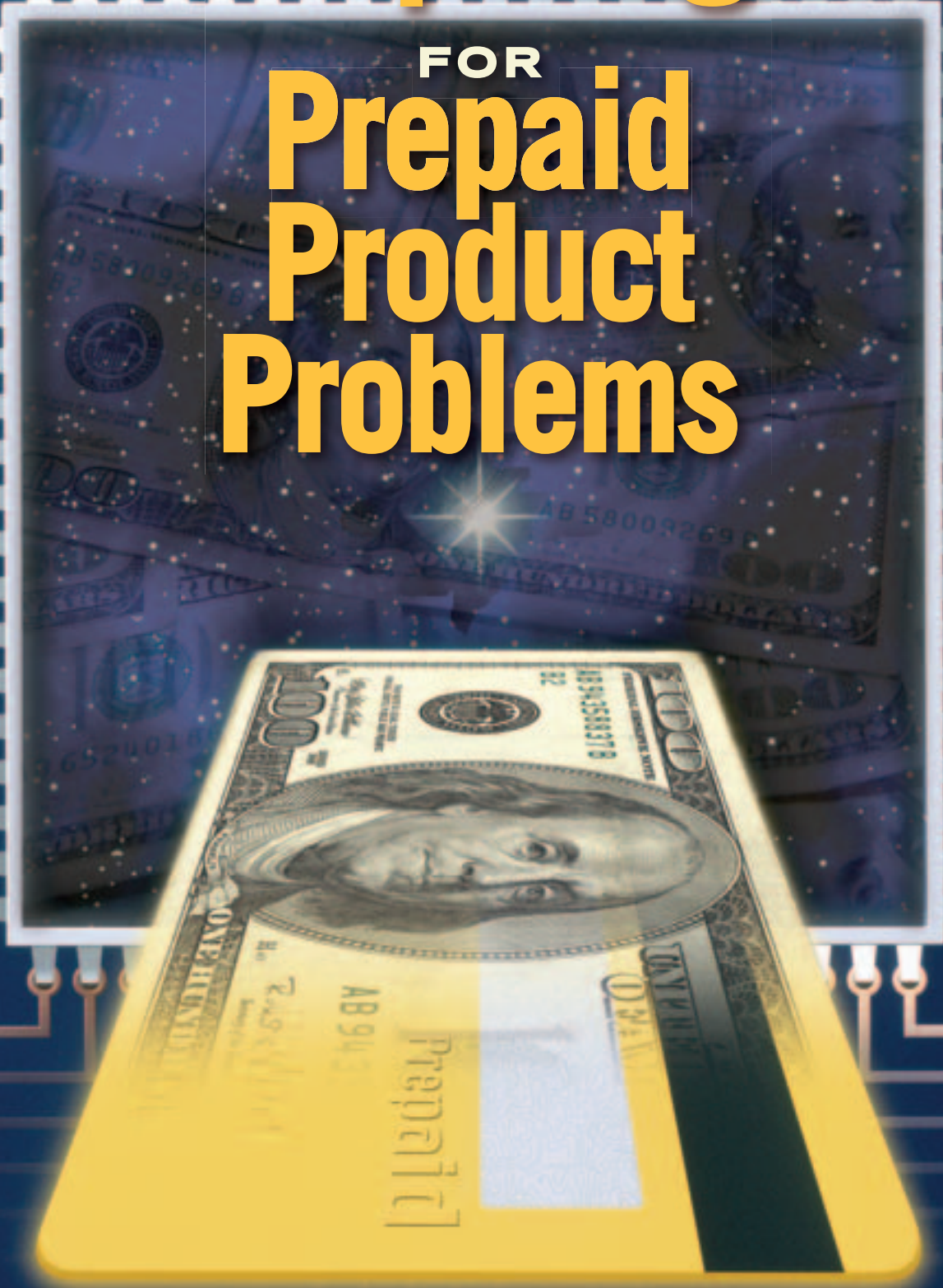


Preparing

FOR

Prepaid Product Problems





BY DEBORAH THOREN-PEDEN

PREPAID CARDS or “stored-value cards” represent some of the hottest new payment products issued and sold by banks and nonbanks alike. But any entity that contemplates issuing, selling, or redeeming prepaid cards must address a number of legal issues—and because some of the legal issues remain unsettled, certain risks accompany prepaid cards. This article discusses the more significant legal and regulatory issues and risks that financial institutions, money services businesses (MSBs), and retailers should consider before issuing or selling prepaid cards.

Types of Prepaid Products

Prepaid card features may assume a variety of configurations. In general, issuers structure prepaid cards as “closed-universe,” “closed but multi-merchant,” or “open-universe” cards. A consumer may use a “closed-universe” prepaid card only at a single merchant (e.g., to buy clothes at a particular retailer). A prepaid card recognized as a payment method by different stores at the same mall represents a type of “closed but multi-merchant” card. Alternatively, a holder can utilize an “open-universe” card to conduct transactions at multiple vendors—such as automated teller machines (ATMs) or any merchant that accepts Visa or Mastercard debit cards.

Many disparate companies issue prepaid cards, including banks, nonbank entities, employers, retailers, and companies that offer products to consumers or others, and even third parties that also provide processing, authentication, and customer service functionalities. Issuers can create prepaid cards that operate effectively as bearer instruments (i.e., anyone who holds the card may use it) or can limit use of a prepaid card to the person to whom it is-

issued the card. Issuers can also configure prepaid cards to require personal identification numbers (PINs) or signatures to authorize transactions. A reload capability allows holders to add value to eligible cards. Issuers limit the function of some cards to purchases of goods or services only, while they offer other cards that allow cash withdrawals or even transfers of funds to other cards or parties.

For the most part, a gift card is just a prepaid card purchased for another party. As the popularity of gift cards has increased, more states have passed laws regulating their usage, permissible fees, required disclosures, limitations on their expiration, etc. State laws often do not clearly indicate whether prepaid cards purchased for another qualify as “gift certificates” subject to various state gift certificate laws or whether they are subject to various state and federal laws and regulations governing at least some prepaid cards (e.g., the Electronic Fund Transfer Act and its implementing Regulation E). Accordingly, one of the major challenges of prepaid cards involves determining which laws regulate them. For example, do state laws that prohibit the inclusion



of an expiration date on a gift certificate apply to prepaid cards issued to any person in that state?

Another popular type of prepaid card, the payroll card, allows employers to offer their employees the option of receiving their salaries in the form of credits to a prepaid card. Some employees (especially those who do not have direct deposit) prefer this option, and some recipients of government or other benefits similarly welcome receipt of their payments via prepaid cards, especially open-universe cards they can use at any of thousands of merchants. Moreover, many parents rely on prepaid cards as a convenient mechanism to provide their children who are students with readily available funds while still retaining control over (at least in terms of amount) their children's spending.

Myriad configurations for prepaid cards exist, and it is highly likely the cards' adoption and use will increase during the next few years. As a result, financial institutions, MSBs, and retailers are increasingly considering whether to issue or sell prepaid cards and, if so, what types of cards they want to offer.

Legal and Regulatory Concerns

Unfortunately, the law has not caught up with the rapid development of prepaid cards, and it is not always clear which laws apply to the various types of prepaid cards. Following are summaries of some of the more substantive federal and state regulatory laws that may apply to prepaid cards, which any entity contemplating issuing, selling, or redeeming prepaid cards should carefully consider.

Federal Laws

BANK SECRECY ACT/USA PATRIOT ACT: Several provisions of the Currency and Foreign Transactions Reporting Act of 1970, commonly known as the Bank Secrecy Act (BSA), 12 U.S.C.A. §§ 1951 et seq. (2004), clearly apply to issuers of stored-value cards. The BSA imposes a number of recordkeeping and reporting requirements designed to combat money laundering, and while many of its provisions apply specifically to banks, most also apply to MSBs.¹ Furthermore, the USA PATRIOT Act amended the BSA to expand significantly the scope of coverage of anti-money laundering (AML) obligations to many nonbanking entities that provide financial services to consumers and to require all covered entities to adopt appropriate AML compliance programs.

AML COMPLIANCE PROGRAM: The USA PATRIOT Act requires all banks, MSBs, and other entities that qualify as financial institutions, including issuers of stored-value cards, to develop, implement, and maintain appropriate AML compliance programs. Significant concern exists that new forms of payment, such as prepaid cards, have a potential risk of misuse by money launderers. Indeed, these new forms of payment have been used to facilitate money laundering, particularly where international transfers and reloads occur

without sufficient oversight.

Developing an appropriate AML compliance program is a considerable undertaking. An AML compliance program must include, at a minimum, four principal elements:

- written internal policies, procedures, and controls designed to reasonably ensure compliance with the BSA and AML laws
- designation of a compliance officer responsible for AML compliance on a day-to-day basis
- ongoing education and training of appropriate personnel on AML laws and the entity's AML policies and procedures
- independent review and testing of the AML program

BSA REPORTING AND RECORDKEEPING REQUIREMENTS: In general, financial institutions and MSBs, including those that sell or redeem stored-value cards, must file currency transaction reports (CTRs) within 15 days (or 25 days if filed electronically) with respect to any transactions involving either cash-in or cash-out of more than \$10,000 in the aggregate by or on behalf of the same customer in one day. All banks and most MSBs must also file suspicious activity reports (SARs). However, MSBs that provide only stored-value services are not required to file SARs, although they may do so voluntarily. An issuer of stored value must carefully consider whether its financial activities consist solely of issuing stored value or whether they also include money transmission or other money services activities that trigger mandatory SAR filing requirements. For example, a transfer of funds from a prepaid card to another party or even another card may be deemed a money transmittal, with respect to which SAR-filing and other requirements apply.

Any financial institution or MSB that must comply with SAR reporting requirements must implement mechanisms to detect and report transactions it suspects involve funds derived from illegal activity, facilitate criminal activity, are designed to evade the requirements of the BSA, or serve no legitimate business purpose. The BSA also imposes recordkeeping as well as other reporting requirements on such transactions.

CUSTOMER IDENTIFICATION PROGRAM: The USA PATRIOT Act mandated that insured financial institutions implement a Customer Identification Program (CIP) procedure for opening new "accounts." Each covered institution must have a CIP program that includes the following elements: (1) a written CIP appropriate for the institution's size and type of business; (2) the CIP must be part of the AML program; (3) the CIP must have risk-based procedures to verify the identity of each customer; and (4) the CIP procedures must specify the identifying information to be obtained from each new customer, including, at a minimum, the name, date of birth (for an individual), street address, and identification number for the customer. To the extent that a prepaid card issued by an insured financial institution is deemed to be an "account" then the bank will need to obtain the requisite information on

What Issuers, Sellers, and Redeemers of Prepaid Cards Should Consider:

- * Carefully **think** through how to structure a program or programs.
- * **Analyze** which laws apply—state, federal, and international?
- * **Evaluate** whether any laws require special licenses.
- * **Consider** privacy concerns related to sharing of personal information in compliance with current laws.
- * Make sure to **send** requisite notices and periodic statements.
- * **Assess** escheat procedures for unused prepaid card funds.
- * Realize that regulators are more likely to **scrutinize** prepaid cards as time passes.

each “customer” and verify the identity of each prepaid “customer” to comply with its CIP requirements. Some banks issuing prepaid cards require the purchaser of a prepaid card to call in or otherwise provide the requisite CIP information to the bank prior to activation of the prepaid card; other banks require such CIP information be obtained and verified before providing a customer an enhanced “open universe” prepaid card that can be used at thousands of merchants; while some others appear to be taking the position that a prepaid card is not an “account” for purposes of the CIP requirements under the USA PATRIOT Act. Accordingly, any insured financial institution that is considering issuing prepaid cards must carefully consider whether it believes its prepaid cards will be subject to the CIP requirements, and if so, determine the procedures it will implement and maintain to comply with its CIP obligations for its prepaid cards.

MSB REGISTRATION REQUIREMENT: BSA regulations require that most MSBs register with the U.S. Department of the Treasury. However, an MSB that only issues, sells, or redeems stored value (and does not engage in any other MSB activity) currently does not need to register. Again, an issuer, seller, or redeemer of prepaid cards must analyze whether regulators may characterize transactions completed using the cards as additional MSB activities, such as money transmittals, in which case the MSB Registration will apply. Registered MSBs must file renewal forms every two years and prepare and maintain lists of their agents.


ELECTRONIC FUND TRANSFER ACT/REGULATION E: The Electronic Fund Transfer Act (EFTA) and its implementing

regulation, Regulation E, may also apply to prepaid cards. In general, EFTA governs electronic fund transfers from accounts initiated via an “access device,” which may include a card or PIN. A basic issue that the Federal Reserve Board (Fed) has just begun to address formally involves whether accounts holding underlying funds for prepaid cards qualify as accounts for EFTA purposes. Assuming EFTA does regulate prepaid-card transactions, it requires the delivery of relatively elaborate disclosures to consumers prior to their purchase or activation of the cards, as well as ongoing periodic statements and specialized receipts. The EFTA would also protect, except in rare cases, a consumer from liability for unauthorized or erroneous transactions. Therefore, whether a prepaid-card issuer must comply with the EFTA presents a significant question. For example, the potential cost of providing monthly periodic statements to consumers detailing their prepaid card transactions as the EFTA mandates may deter a business from issuing prepaid cards. Similarly, an issuer that must, under the EFTA, assume responsibility for virtually any type of erroneous or unauthorized use of a prepaid card undertakes a different risk analysis from one taking the position that such transactions remain the cardholder’s obligation. Current law does not clearly differentiate which types of prepaid cards the EFTA does or does not cover. Accordingly, any entity considering issuing prepaid cards needs to analyze carefully the possible risks and burdens related to compliance with the EFTA and Regulation E.

On September 13, 2004, the Fed released proposed amendments to Regulation E that would expand its coverage to payroll card accounts that an employer establishes either directly or indirectly on behalf of its employees to provide salary, wages, or other compensation on a recurring basis. Regulation E would apply to a payroll card account regardless of whether the employer, a third-party payroll processor, or a depository institution managed it. The deadline for comments to the proposed rule was November 19, 2004.

FDIC INSURANCE: Another issue surrounding prepaid cards involves whether the Federal Deposit Insurance Corporation (FDIC) will extend the maximum level of insurance protection to accounts holding commingled funds underlying prepaid cards (i.e., up to \$100,000 per cardholder, as opposed to \$100,000 for the entire account). FDIC regulations address, among other things, the availability of FDIC insurance for accounts an agent or custodian establishes for the benefit of others, in which it commingles funds of the beneficial owners. The FDIC calculates the amount of insurance available to each beneficial owner of funds in a commingled account based upon the actual ownership of the funds and documentation of such ownership. In essence, the FDIC currently allows deposit insurance to “pass through” an agent or custodian to the actual owner of the funds under certain circumstances.


The FDIC imposes two requirements on eligibility for pass-through insurance coverage. First, the title of the account must



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indicate its fiduciary or custodial nature. Second, either (i) the deposit account records of the insured depository institution, (ii) records maintained by the agent or custodian in good faith and in the ordinary course of business, or (iii) records maintained for the depositor by a third party in good faith and in the ordinary course of business must reflect the ownership interest of each beneficial owner in the pooled funds.

The FDIC is currently considering the scope of available insurance coverage for prepaid cards funds. On April 16, 2004, the FDIC issued a proposal that, if adopted, would broaden the definition of “deposit” to include most funds underlying prepaid cards (including most funds in pooled accounts), provided that the means or records exist to identify the amount of funds owned by a particular cardholder.



OFAC REGULATIONS: Issuers of prepaid cards must comply with the regulations of the Office of Foreign Assets Control (OFAC) of the Treasury Department. OFAC administers and enforces economic and trade sanctions issued in furtherance of U.S. foreign policy and national security goals, and all U.S. businesses and persons must comply with OFAC regulations. As part of its enforcement efforts, OFAC publishes a list of specially designated nationals or SDNs that includes individuals, companies, targeted countries, and others engaged in terrorist activity, international drug trafficking, or the proliferation of weapons of mass destruction. OFAC generally prohibits U.S. persons and entities from conducting transactions with SDNs and requires blocking of SDNs’ assets. OFAC regulations do not contain an exception for de minimus transactions. Accordingly, a financial institution, MSB, or other business may violate OFAC regulations by issuing, selling processing, or redeeming a prepaid card transaction of any amount that involves an SDN or other entity subject to the OFAC economic sanctions. Financial institutions that are considering offering prepaid cards should carefully consider how they would comply with the OFAC regulations.

PRIVACY/GRAMM-LEACH-BLILEY ACT: Title V of the Financial Modernization Act of 1999, also known as the Gramm-Leach-Bliley Act (GLBA), includes provisions that protect consumers’ personal financial information held by financial institutions. The GLBA defines “financial institutions” broadly to include most companies that offer virtually any type of financial product or service to individuals. The issuance of stored-value cards to consumers will likely qualify as a financial activity governed by the statute.

Under the Financial Privacy Rule of the GLBA, covered financial institutions must provide detailed and specific privacy notices to their customers, generally prior to opening their accounts or collecting personally identifiable information, as well

as annually thereafter (where there are “continuing” account relationships). In many cases, a financial institution must provide a consumer the right to opt out of the financial institution’s sharing of his or her personally identifiable information with third parties. The GLBA also imposes significant limitations on the use and reuse of personally identifiable information shared with any third parties. The Safeguards Rule of the GLBA requires all financial institutions to design, implement, and maintain commercially reasonable safeguards to protect customer information. Accordingly, any entity that qualifies as a “financial institution” under the GLBA needs to take care to ensure it complies with its obligation to provide privacy notices to its customers and with its other GLBA requirements.

OTHER FED REGULATIONS: A number of other regulations promulgated by the Fed may also apply to prepaid cards. Regulation D imposes uniform reserve requirements on all depository institutions with transaction accounts or nonpersonal time deposits and requires the submission of reports to the Fed. Regulation D sets forth rules for computing the amount of reserves that an institution must hold and the methods for holding them. The Fed has not yet delivered an opinion as to whether funds underlying prepaid cards qualify as an account for purposes of Regulation D. If it determines that these funds do qualify as an account within the definition of “transaction accounts” under Regulation D, then banks maintaining such accounts will need to have maintained a reserve against the deposits to such accounts and also complied with Regulation D’s reporting requirements.

Regulation CC requires that financial institutions provide customers who have transaction “accounts” disclosures stating when their funds deposited at the financial institution will be available for withdrawal. As many prepaid cards may be purchased only with cash or via a credit card, the “availability” of such funds in most cases must be provided by the first business day following the banking day of deposit, and the bank will need to simply ensure that the disclosures that it provides to its customers properly reflect its practices. However, in some cases, customers may be allowed to purchase a prepaid card with a check, in which case a bank that does not want to provide next day availability (or immediate availability) for the funds may be required to provide specialized hold notices under Regulation CC.

Similar to Regulation D, Regulation CC applies to financial institutions that maintain “accounts,” and one of the undecided issues is whether the funds underlying prepaid cards qualify as “accounts” for purposes of Regulation CC. In the event that prepaid cards are determined to be “accounts” for purposes of Regulation CC, then the financial institutions holding such

funds will need to have complied with Regulation CC.

Finally, the Truth in Savings Act and its implementing Regulation DD require depository institutions to disclose terms of “deposit accounts” to consumers so they can make informed decisions. Under Regulation DD, depository institutions must disclose consumer yields, fees, and other terms concerning deposit accounts at the time of account opening, upon request, when changes in terms occur, and in periodic statements. Regulation DD also includes rules about advertising for deposit accounts. A financial institution holding funds under a prepaid card program should also consider whether it is maintaining an account subject to Regulation DD, and, if the “account” is interest bearing, it will need to confirm that it has complied with the various disclosure and other requirements of Regulation DD.

Failure to comply with the applicable federal laws and regulations may result in the imposition of regulatory actions, fines, and sanctions for compliance violations. Participants in the prepaid program or others may also file lawsuits seeking damages.

OCC GUIDANCE: The Office of the Comptroller of the Currency (OCC) issued a report in 1996 providing some guidance regarding stored value systems. The report raised a number of issues and recommended the delivery of appropriate disclosures regarding how consumers can use stored-value cards; where and how holders can add value to cards; whether electronic cash earns interest, dividends, or any additional returns; and where, how, and when consumers can redeem electronic cash. The report also suggested that issuers provide specific disclosures to consumers regarding fees issuers may charge to receive or use cards, the names of issuing entities, the types of protection consumers have for lost or stolen cards, the potential FDIC insurance for stored-value cards, the responsible party for unauthorized transactions, the treatment of abandoned cash and expirations, the dispute resolution process, and the sharing of consumer transaction information with third parties.

In May 2004, the OCC released an advisory letter regarding the laws and risks associated with payroll cards. In that letter, the OCC recommended that, while waiting for further guidance on the application of various laws and regulations, banks “comply with the substance of those laws and regulations to protect...against reputation risk and future compliance risk.” It also cautioned that banks should address the disclosure of material terms, applicable privacy policies, fees, the handling of lost or stolen cards, locations that will accept the cards, methods for accessing the cards, error-resolution procedures, and limits on consumer liability for erroneous or unauthorized transactions (including exceptions or variations for ATM- or PIN-based transactions). Additionally, the OCC suggested that banks evaluate the risk related to the potential use of cards to support payday lending and abusive overdraft terms as well as analyze risk exposures,

including the availability of deposit insurance and potential bankruptcy of third parties holding funds.

State Laws

In addition to federal regulations, state laws also apply to prepaid cards. One of the greatest challenges facing those involved in the stored-value card industry involves determining which of the myriad of regulations enacted by the 50 states and the District of Columbia may govern such cards. Currently, more than half the states have proposed new legislation related to gift cards or prepaid cards. It is also important to remember that most state laws do not clearly differentiate between stored-value cards and gift cards.

LICENSURE: License requirements present significant issues that may impact issuers, sellers, administrators, and redeemers of prepaid cards. Many states (and the number continues to grow) require licenses (usually money transmission licenses) to issue or sell prepaid cards. Under some laws, any party that holds or controls the sales proceeds of prepaid cards, even for only a day or two, must obtain a license or enter into a contract with the issuer, pursuant to which the party must hold the proceeds in a fiduciary capacity and subject to regulatory oversight. Still other states are considering whether the payment for a prepaid card (especially one that allows funds transfers to other cards and operates essentially as a checking account) triggers state laws that require a banking license for taking deposits.

Many state statutes exempt from their license requirements banks and entities that have entered into contracts to serve as authorized delegates where a bank is issuing the prepaid cards. The provisions that an authorized delegate agreement must contain vary from state to state. However, some states only exempt from licensure banks that hold licenses to conduct business in their states.

Some of the state laws tie licensure issues to functionality. For example, states may factor whether a prepaid card is a closed-universe or open-universe, whether a holder can reload value onto the card, or whether a consumer may conduct fund transfers or funds transmittals using the card. Generally, the trend favors requiring a money transmission license, but a number of states grant exceptions for the sale of closed-universe cards.

ABANDONED FUNDS/STATE ESCHEAT LAWS: Most states have enacted unclaimed property or escheat laws that can significantly impact prepaid cards. Such laws may require holders of unclaimed or abandoned property to file a report with and deliver the property to the state after they have not had any contact with the owners of the property for a certain amount of time. The application of escheat laws to prepaid cards varies greatly from state to state. Some states require reporting of unused funds underlying stored-value cards, while others exempt gift cards from escheat obligations. Some (e.g., California) do not require escheat for closed-universe



gift cards that never expire² (“evergreen” provisions). Some plaintiffs, however, have filed lawsuits to require cash redemption for cards.

When does unclaimed property escheat to the state? The timing may depend on the date of issuance or expiration (if applicable) of the card or the date of the card’s last use. Typically, states require escheat either upon a card’s expiration or anywhere from two to seven years after the date of issuance or last use of the card.

To which state does an issuer report unclaimed property? The method for determining where to report differs by state and depends on the information the holder possesses regarding the owner of the card. Generally, a holder should report unclaimed property to the state of the owner’s last known address, if the holder has that information. Otherwise, the abandoned property will likely escheat to the holder’s state of incorporation. Some states have now enacted recordkeeping requirements for gift card sales. Additionally, some states require that specific notices be sent to the purchasers or recipients of prepaid cards advising them of the impending escheat of the unused value of the cards if the owner of the card does not make claim to it. The timing on when such notices must be sent, the verbiage to be included in the notice, and the circumstances under which and to whom the notice must be sent (some are only required if \$50 or more may be escheated) vary from state to state.

SERVICE FEES/DORMANCY FEES: States are also concerned with dormancy and other administrative fees applied to cards. Some states limit or prohibit such fees outright, while other states limit or prohibit them under their unclaimed property laws because such fees arguably diminish the value of the unclaimed property otherwise reportable to the states. For example, some states may consider the imposition of dormancy fees as a private attempt to escheat, which certain state laws prohibit. In 2004, California enacted legislation restricting the imposition of service fees or expiration dates on closed-universe gift cards. In addition, the reasonableness of the fees charged may factor into whether a state permits, limits, or prohibits their assessment.

FEES FOR CASHING PAYROLL INSTRUMENTS: The issue of whether fees may apply to cashing payroll instruments such as checks under state law may also impact payroll cards. Some state laws that prohibit the diminution of value on encashment of a payroll check could arguably also apply to prepaid payroll cards. If employers offer the option of receiving salary payments by crediting payroll cards, laws limiting or prohibiting fees to cash payroll instruments may apply to the cards. While the law has not settled this issue, class action lawsuits filed in California in 2004 against banks that charged fees to noncustomers cashing payroll checks drawn on the bank serve as a notice that this is an active issue.

PRIVACY LAWS: State privacy laws, which relate to the usage and sharing of personally identifiable information, also raise issues for prepaid cards. Issuers, sellers, or redeemers may need to deliver mandatory disclosures and implement notice policies before collecting a cardholder’s personally identifiable information. Some states require notices to consumers in the event of unauthorized access to their information. Some states may require that a customer be given opt-out or even opt-in rights prior to having their personally identifiable information obtained in connection with a prepaid card shared with affiliates or third parties. Concerns also arise as to how a cardholder

can receive information about card transactions and the remaining value on a card if it becomes lost or stolen. Additional restrictions apply if the prepaid card also functions as a club card, as some states prohibit any sharing of club card information for marketing purposes. Furthermore, unfair business practice laws may come into play for violations of the club card rules.

EFFECT OF LEVY OR BANKRUPTCY: Issuers of prepaid cards should evaluate how certain state laws treat the ownership of the underlying funds. For example, are the funds protected from a levy against or bankruptcy by the issuing, administrative, or custodial entity? The resolution of this issue may depend on whether a custodial record exists or whether the holder of the funds clearly maintains them in a fiduciary capacity. If nothing clearly indicates the funds as being held in a custodial or fiduciary capacity, the funds may be subject to a levy. In addition, prepaid card issuers should consider the viability of potential creditors’ claims in the event the issuer, administrator, or custodian files for bankruptcy and should take appropriate action to protect the underlying funds from the bankruptcy estate.

While prepaid cards offer innovative and exciting methods of payment, they also raise a host of legal issues, many of which remain unsettled. Banks and nonbanks must seriously analyze the legal issues surrounding these new payment forms to fully assess their risks and benefits. BC

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Deborah Thoren-Peden is a partner at Pillsbury Winthrop LLP who represents banks, money services business, retailers, and non-banks on a variety of matters. She heads the firm’s Consumer and Retail Practice Group. She advises numerous clients on a nationwide basis on their legal responsibilities related to gift cards, prepaid cards, and payroll cards. She helps clients design, implement, and maintain their gift and prepaid card programs, negotiate agreements related to the same, interfaces with state and federal regulators, and, where necessary, obtain state licenses required to issue, sell, or redeem prepaid cards. She has assisted other Retail Practice Group attorneys at the firm who have successfully defended issuers and sellers of prepaid cards in some of the class action and other lawsuits that have been filed related to gift cards. In 2001 she received the Frandzel Award from the California Bankers Association for Superior and Noteworthy Legal Assistance by Outside Counsel, and in 2004, she was named as a Southern California Superlawyer by the Los Angeles Magazine. She is also identified as a “Recommended Lawyer” by the Global Council 3000 publication for 2003/2004. She may be reached at thoren@pillsburywinthrop.com.

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References

¹ BSA regulations define MSBs as including each agent, agency, branch, or offices of any person that offers currency exchange, check cashing, traveler’s checks, money orders, stored-value, or money transmission services. 31 C.F.R. § 103.11(uu).

² California law prohibits expiration dates on such gift cards.