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Operation Choke Point draws fire from Congress, industry



In what some are calling the week of Operation Choke Point, four congressional hearings were held over a three-day period in mid-July 2014. The hearings raised serious concerns about the operation's legal authority and unintended impact on legitimate businesses operating within a number of congressional districts.

The Department of Justice-led initiative launched in early 2013 to investigate banks and payment processors suspected of knowingly doing business with fraudulent merchants. The action is a directive of the Consumer Protection Branch of the Financial Fraud Enforcement Task Force. The FFETF coalition of law enforcement, investigatory and regulatory agencies was established in 2009 by President Obama to combat financial fraud.

In February 2013, Michael Blume, Director of the Consumer Protection Branch, sought permission from Stuart Delery, Assistant Attorney General in the DOJ's Civil Division, to authorize issuance of subpoenas under the Financial Institutions Reform, Recovery and Enforcement Act of

1989 (enacted to shore up the Federal Deposit Insurance Corp. system after the savings and loan debacle in the late 1980s). The subpoenas were needed to launch Operation Choke Point investigations directed at seven entities.

In March 2013, FFETF Executive Director Michael Bresnick said in a speech, "We hope to close access to the bank system that mass marketing fraudsters enjoy – effectively putting a chokehold on it – and put a stop to this billion-dollar problem." He also stated that the CPWG had "prioritized the role of financial institutions and payment processors in mass marketing fraud schemes, including payday lenders" and other high-risk merchants identified in a list circulated by the FDIC.

By the end of 2013, the DOJ had issued over 50 subpoenas to banks and payment processors in connection with Operation Choke Point investigations. While none of the entities subpoenaed were publicly identified by regulators, the case of Four Oaks Fincorp Inc. became public in January when the bank agreed to a \$1.2 million settlement for allegedly processing payments for fraudulent merchants.

Under House scrutiny

In January 2014, Rep. Darrell Issa, R-Calif., Chairman of the House Committee on Oversight and Government Reform; along with Rep. Jim Jordan, R-Ohio, Chairman of the Subcommittee on Economic Growth, Job Creation

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effective, an ETA member survey revealed that more than 10,000 fraudulent merchants were discharged by acquirers over the past year due to effective fraud detection programs already in place.

Two ETA-commissioned economic studies supported assertions made during the hearing. In one study, *Economic Effects of Imposing Third-Party Liability on Payment Processors*, NERA Economic Consulting concluded that the DOJ focus on payment companies was misplaced and ineffectual when compared with industry self-regulation efforts.

In the second study, *The FTC's Potential Impact on the Merchant Acquiring Industry*, author Raymond Carter, Principal at First Annapolis Consulting Inc., reached a more disconcerting conclusion. "The position paper that I wrote is about how the FTC's proposed actions are very different from the way that the industry is designed and operates today in that they're potentially going to consider holding merchant acquirers responsible for the liability of all transactions processed by a merchant that has done something that the FTC believes is illegal," Carter noted.

What to expect next

As Congress prepared to take an August recess, it appeared unlikely any bill to curtail Operation Choke Point would be enacted into law this year. However, the payments industry must remain vigilant, and ETA has setup a petition drive online, which can be viewed at <http://www.change.org/petitions/u-s-house-of-representatives-tell-congress-operation-chokepoint-is-choking-off-legitimate-commerce>.

"My hope is that federal agencies like the DOJ and the FTC and others will see the payments industry as a better partner than a target in their investigation of fraud, and that public outcry over what Operation Choke Point is doing will result in a change of policy at these federal agencies to one that pursues fraudulent merchants instead of innocent payments companies," said Jason Oxman, ETA Chief Executive Officer.

Attorney Michael Thurman, of Thurman Legal, agreed with Oxman that efforts should focus on enhancing rules for merchant categories under question, which has been effective elsewhere. "To me, that is the perfect model for this situation, where if the regulators would lay out the rules and, rather than legislate by threatened enforcement, actually provide stringent guidelines that are the result of rulemaking and the industry and public having the opportunity to weigh in," Thurman said.

Also worth noting is that neither the FTC nor the DOJ carry rule-making authority. "It reminds me of the old adage that 'when all you have is a hammer, everything looks like a nail,'" Thurman said. "That's my sense of what's going on with Operation Choke Point. You have two agencies that only have a hammer available to them, and so they're using it."

Operation Choke Point best strategies

In light of the DOJ's Operation Choke Point investigations, following are several strategies to heighten awareness and encourage greater collaboration in the fight against fraudulent merchants:

- Adopt and enforce strict underwriting and risk monitoring procedures, and offer frequent training. An excellent resource is the ETA's *Guidelines on Merchant and ISO Underwriting and Risk Monitoring* published this year.
- Integrate an effective Know Your Customer (KYC) program, such as the one offered by G2 Web Services called KYC Governor. Programs like this are designed to prevent boarding of merchants that fall outside risk parameters known to trigger Operation Choke Point subpoenas.
- Sign the ETA Operation Choke Point petition drive online at <http://www.change.org/petitions/u-s-house-of-representatives-tell-congress-operation-chokepoint-is-choking-off-legitimate-commerce>. This strongly communicates to Congress that Operation Choke Point is choking off legitimate businesses.
- Inform congressional members in your district that you support pro-business bills, for example H.R. 4968, that offer safe harbor to third-party payment processors and banking institutions that cooperate in the ongoing effort to identify and prosecute fraudulent merchants.

But legislators must exercise caution. "What we don't want is some drastic law that will be so burdensome that it will interfere in commerce," said payments attorney Adam Atlas. "We're already carrying some of the burden of the wrongdoing that's being perpetrated by folks through processing. But what Operation Choke Point appears to be doing is to engage the liability of the processors for more than just the commercial value of the transaction."

In the worst case scenario, legitimate high-risk merchants might be driven offshore to less scrupulous processors, which is why self-regulation remains a critical component. "That is why, prudently, ETA came up with the industry self-regulation guidelines," Atlas said. "What I think you can probably expect is major processors and acquirers to roll these principles into their own underwriting practices. These are then echoed down in the ISOs that have to live by those sets of rules."

Looking ahead, Atlas sees plenty of opportunity for specialization in high-risk merchants for a handful of acquirers and ISOs that are willing to comply with new rules of engagement. "For the right price, there is lots of processing to be done out there," Atlas said. "I think, fortunately, that the laws of supply and demand will intervene to give a new life to high-risk processing, perhaps with better controls, to see that true criminals are not involved." ☒