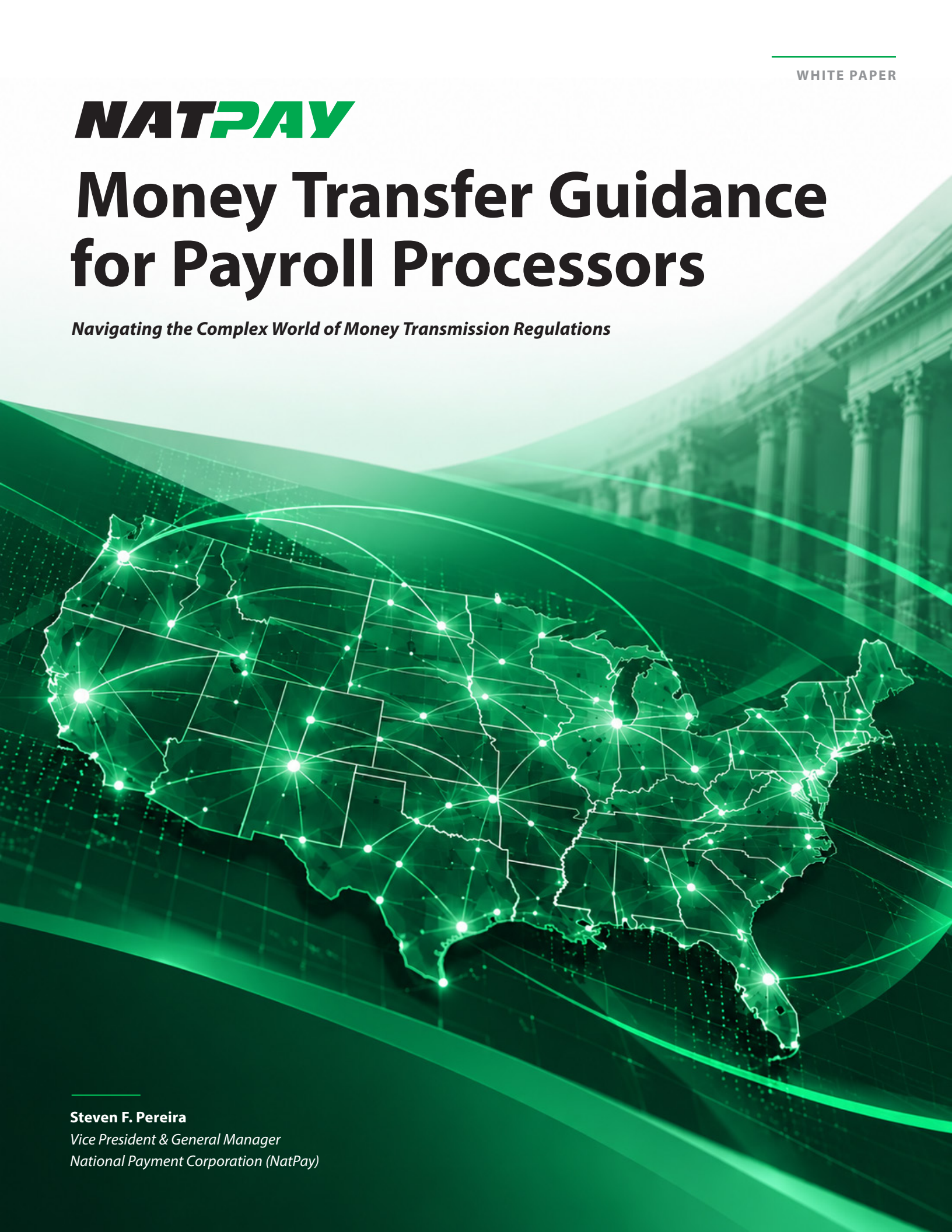
WHITE PAPER

NATPAY

Money Transfer Guidance for Payroll Processors

Navigating the Complex World of Money Transmission Regulations



Steven F. Pereira
Vice President & General Manager
National Payment Corporation (NatPay)

First, an important disclaimer: *Nothing in this paper should be construed as legal advice. My purpose is simply to share insights, observations, and lessons learned from considerable real-world experience navigating the complex and often frustrating world of money transmission regulation.*

And believe me, it is a complicated world.

The regulatory landscape surrounding Money Services Businesses (MSBs) and money transmission can be intimidating, expensive, and, frankly, stressful. The rules vary considerably from state to state, regulatory interpretations are not always consistent, and obtaining the necessary licenses can be an extraordinarily difficult and costly undertaking.

For payroll processors, the challenge is particularly significant because activities that have traditionally been considered routine components of payroll processing may also attract the attention of state money transmission regulators.

When Does a Payroll Processor Become a Potential Money Transmitter?

Let me begin with a fundamental point: **If you impound funds for payroll, taxes, or other disbursement purposes, you may be engaging in activities that cause regulators to consider you a money transmitter.**

And here's something that often surprises payroll processors: It doesn't necessarily matter where your company is headquartered.

If you have even a single customer located in a state that considers your activities subject to its money transmission laws, you may find yourself facing regulatory scrutiny in that state.

The purpose of this paper is to help you understand these risks, identify ways to minimize your regulatory exposure, and, perhaps most importantly, prepare yourself should a state regulator decide to examine your business.

Because once that process begins, it can become extraordinarily expensive, time-consuming, and disruptive.

How NatPay Can Help Reduce Your Exposure

Some payroll service bureaus utilize NatPay's payroll services specifically because our involvement can help insulate them from a substantial portion of the regulatory scrutiny associated with moving payroll funds.

However, that protection is not necessarily absolute.

If you continue to impound funds for certain payroll-related activities, including check issuance, direct payroll funding from clients through wires or other methods, tax payments, or traditional escrow services, you may still have regulatory exposure.

In other words, the regulatory veil can still be pierced.

And if you perform all these services independently, perhaps using your own bank accounts to collect and disburse funds, you may be exposing yourself to the full range of state money transmission requirements.

Consider the experience of Paycor, Inc., a major payroll service provider, which faced an enforcement action and a fine exceeding $275,000 from the State of Texas.

Paycor, Inc. was not headquartered in Texas, but its activities involving Texas customers were sufficient to bring it within the state's regulatory jurisdiction.

The lesson is simple: Your company's physical location does not necessarily determine the extent of your regulatory obligations.

What Happens When a State Decides to Examine Your Business?

Let's assume the worst has happened.

A state regulator has determined that your business activities warrant further investigation, and you have received notice of an examination.

Now what?

You need to be prepared to produce detailed financial information, transaction histories, account records, and operational documentation addressing the very specific questions regulators typically ask.

And they will ask plenty.

1. Transaction Volumes and Customer Locations

One of the first things regulators typically want to know is how much money you transmit using impounded customer funds.

This information helps them determine the extent of your business activities within their state and may influence the size of any potential penalties if they conclude that you should have obtained a license before conducting those activities.

And don't assume they will limit their review to the most recent year.

Regulators can look back a very long time.

For this reason, your payroll software should be capable of identifying customers by state and producing historical reports showing the volume and value of transactions attributable to each jurisdiction.

If your systems cannot readily produce this information, you may face an extremely difficult and expensive data-gathering exercise.

2. Financial Statements and Capitalization

The next request will almost certainly involve your company's financial statements.

Regulators use this information, together with your transaction volumes, to evaluate whether your business maintains sufficient financial resources relative to the amount of customer money moving through its accounts.

In some states, independently audited financial statements are required. Even where they are not specifically mandated, professionally prepared financial statements can be extremely helpful.

The underlying question is straightforward:

Does your company have the financial strength to support the amount of customer money it handles?

3. Operational Procedures, Transaction Records, and Account Controls

If regulators decide to pursue the examination further, you should expect increasingly detailed requests concerning your transactions, bank accounts, internal controls, and overall business model.

They will want to understand exactly how money enters your organization, where it is held, how it is monitored, and how it ultimately reaches its intended recipients.

This is where things can become particularly challenging.

Before discussing the examination process further, I want to address several operational practices that every payroll processor handling customer funds should seriously consider, regardless of whether they use NatPay's services.

The Double Whammy: Compliance and Operational Oversight

If you perform your own payroll funding and disbursement services, you may find yourself dealing with two significant areas of regulatory scrutiny.

The first involves your compliance policies and procedures, including applicable Bank Secrecy Act (BSA), Anti-Money Laundering (AML), and customer due diligence requirements.

The second involves your operational controls, financial accountability, and ability to demonstrate that customer funds are properly safeguarded.

Although the specific requirements vary by jurisdiction and business model, regulators may examine your written policies, customer underwriting documentation, transaction monitoring procedures, fraud prevention measures, and security controls.

They may also want to review your entire operational workflow.

How are customers evaluated? How are transactions authorized? What systems protect sensitive information? What procedures are in place to identify suspicious activity or prevent fraudulent transactions?

For payroll processors using NatPay's services, our existing compliance infrastructure and operational controls can help address portions of these concerns, depending on the services being provided and the activities retained by the processor.

And here's a little-known bonus of regulatory examinations:

In some circumstances, you may be responsible for paying the costs of the examination itself.

That one came as something of a surprise to us.

Imagine being required to fund your own involuntary colonoscopy.

Not exactly an experience anyone looks forward to.

Every State Has Its Own Priorities

One of the most frustrating aspects of money transmission regulation is the lack of uniformity among the states.

Each jurisdiction may have its own interpretation of the law, its own examination procedures, and its own particular areas of concern.

We have dealt with one state whose primary focus was ensuring that employees would still receive their wages if a payroll processor or its customer failed financially.

Another state was intensely focused on the segregation of impounded funds and required a very specific type of custodial arrangement, commonly referred to as a **For Benefit Of (FBO) account**.

And that introduces an entirely different set of challenges.

Banks may advertise FBO account services, but not every arrangement described as an FBO account necessarily satisfies the requirements of a particular regulator.

Depending on the bank and the structure involved, establishing a qualifying custodial arrangement may require substantial internal approvals, specialized documentation, and additional compliance oversight.

And these arrangements can be expensive.

The important point is that simply asking your bank for an FBO account does not guarantee that the resulting arrangement will satisfy the expectations of every state regulator.

Account Reconciliation: An Absolute Necessity

Regardless of how extensively you utilize NatPay's services, you should be prepared to demonstrate that every account holding customer funds is properly and consistently reconciled.

This is one of the most important operational disciplines you can establish.

In our experience, state examiners place tremendous emphasis on account reconciliations, bank statements, and the ability to demonstrate that customer funds are fully accounted for.

Many regulators are accustomed to reviewing monthly statements and reconciliations tied to a traditional month-end accounting cycle.

Interestingly, this created a challenge for us.

At NatPay, we have historically preferred reconciling our accounts weekly because we believe waiting an entire month to discover a discrepancy introduces unnecessary risk.

From an operational standpoint, more frequent reconciliation makes perfect sense.

But convincing regulators accustomed to monthly reporting cycles that our approach was equally effective, or potentially more effective, was surprisingly difficult.

The money transmission industry encompasses a wide variety of businesses, and payroll processors represent only a small portion of the entities these departments regulate.

Consequently, examination procedures are often designed around business models that operate very differently from ours.

The practical takeaway is this: Maintain accurate, timely reconciliations, but also be prepared to produce the month-end documentation and reporting formats your regulator expects.

Outstanding Liabilities: The Report That Can Make Your Life Miserable

Now we come to one of the most challenging requirements of all.

Outstanding liabilities.

Regulators can become almost obsessive about this subject.

And, to be fair, I understand why.

If you maintain an account containing money belonging to your customers, regulators want to know precisely how much of that money belongs to each customer at a given point in time.

It is not enough to demonstrate that the bank account reconciles.

You must also be able to identify the underlying obligations represented by the funds remaining in that account.

For example, at the end of a monthly reporting period, you may be expected to produce a detailed outstanding liabilities report identifying each customer and the amount of their funds that remains in your possession or is otherwise awaiting disbursement.

The aggregate amount of those outstanding obligations should reconcile to the corresponding customer-fund balances, with any reconciling items properly identified and explained.

In simple terms, **you need to be able to account for every dollar of customer money and explain exactly whose money it is and why it is still there.**

For tax impounds, this can be difficult enough.

For payroll impounds, it can be an absolute nightmare.

Think about the variables involved: Different payroll schedules, varying funding methods, multiple settlement cycles, returned transactions, adjustments, and the timing differences between when funds are collected and when payments are actually completed.

All of these factors can complicate the process of identifying outstanding obligations at a particular point in time.

And yet regulators may expect you to produce this information accurately, consistently, and on demand.

Trust me, this is one of those reporting requirements that sounds much easier than it actually is.

It's nasty.

Your Impound Account: Make Its Purpose Absolutely Clear

For years, I have strongly recommended that payroll processors take a very deliberate approach to how their impound accounts are established and identified.

At a minimum, the account name and supporting bank documentation should make it clear that the funds are being held for the benefit of customers and are not simply the operating funds of the payroll processor.

Some banks do not have a convenient checkbox or account designation that adequately describes the custodial nature of these funds.

If that is the case, make sure the purpose of the account is explicitly discussed with the bank, properly documented, and reflected in the account structure wherever possible.

There is absolutely nothing to be gained by attempting to conceal the true purpose of an impound account from your bank.

Banks can become extremely concerned when they discover that an ordinary business account is being used to collect, hold, and disburse substantial amounts of third-party funds without their knowledge or approval.

In some cases, that discovery can lead to an account being restricted or closed.

But there is an even more serious concern.

It involves an unpleasant little banking term called **set-off**.

Under certain circumstances, a bank may have contractual or legal rights to apply funds held in an account against debts owed to that bank.

Imagine falling behind on a business loan and discovering that the bank has exercised set-off rights against an account containing money you were holding for payroll disbursements.

That is a nightmare scenario.

Properly structured and documented custodial accounts can help address this risk, although the actual protections depend on the account arrangement, governing agreements, and applicable law.

The bottom line is simple: Make sure your bank understands whose money is in the account, why it is there, and how it is intended to be used.

Earning Interest on Customer Funds: A Potential Regulatory Red Flag

Here is another issue that payroll processors may not particularly enjoy hearing about.

Deriving financial benefit from customer funds can complicate your regulatory position.

One argument that has been relevant in certain regulatory discussions is that a payroll processor impounds funds solely because doing so is necessary to perform the underlying payroll service.

In other words, holding and moving money is incidental to providing payroll services, rather than the primary purpose of the business.

That distinction can be important, depending on the applicable law and the facts of the arrangement.

But what happens when the processor earns interest on the funds being held?

Suddenly, the money is serving an additional economic purpose.

The processor is receiving a financial benefit simply from possessing customer funds, which may undermine the argument that holding those funds is merely incidental to payroll processing.

It does not automatically mean that the processor is a money transmitter, but it can introduce additional questions and regulatory concerns.

We experienced the financial consequences of this issue firsthand.

In 2007, the interest we had been earning on our accounts was eliminated under our bank's treatment of what it referred to as "**hot money**."

Hot money, in this context, generally refers to funds that are not owned by the account holder and are expected to move through the account relatively quickly.

The bank's position was that these types of balances should not earn interest under its applicable policies.

That decision hurt.

But it also reinforced an important lesson: The way customer funds are held, classified, and used can have significant financial and regulatory consequences.

Preparing Before the Regulators Come Knocking

This paper is considerably longer than most of the white papers I typically publish.

But there is a reason for that.

Money transmission regulation is a remarkably complex subject. Payroll processors must contend with a patchwork of state laws, differing regulatory interpretations, multiple licensing structures, and examination procedures that are anything but uniform.

For many payroll service bureaus, the mere prospect of becoming subject to these requirements is enough to inspire genuine fear.

And I understand that reaction completely.

Having spent considerable time dealing with these issues firsthand, I can tell you that the administrative burden alone can be overwhelming. But there is something you can do about it.

Prepare now, before you receive that first regulatory inquiry.

Make sure your bank accounts are properly structured and documented. Establish consistent reconciliation procedures. Understand where your customers are located and how much money you process on their behalf. And, perhaps most importantly, determine whether your payroll systems can accurately identify and report outstanding customer liabilities.

These are not simply regulatory housekeeping exercises.

They are fundamental controls that can help protect your business, your customers, and the funds entrusted to you.

A Final Word — and Yes, a Blatant Pitch for NatPay

I'll close with a little shameless self-promotion.

NatPay can help protect your business from a substantial portion of these regulatory headaches.

And we can do it without burying you under an avalanche of unnecessary rules or forcing you to completely redesign your existing payroll processing cycles.

How extensively you choose to utilize our services is entirely up to you.

But regardless of whether you use NatPay for some or all of your payroll funding and disbursement activities, now is an excellent time to evaluate your exposure and get your financial reporting in order.

Make sure your accounts reconcile. Make sure your documentation is complete. And make sure you can explain, at any given point in time, exactly how much customer money you are holding and to whom it belongs.

If your payroll system cannot readily produce an outstanding liabilities report, don't assume the problem is insurmountable.

I'm reasonably confident I can help.

We can examine the reports your system currently generates and work together to determine how that information might be organized, reconciled, or adapted to produce what regulators expect.

Sadly, after years of dealing with these challenges, I've become remarkably good at it.

And if that experience can save another payroll processor from some of the headaches we've endured, then at least something good has come from all those regulatory examinations.



Steven F. Pereira
Vice President & General Manager
National Payment Corporation (NatPay)