

WRITTEN STATEMENT

OF

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Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, my name is Rick Fischer. I am a partner in the law firm of Morrison & Foerster, and practice in the firm's Washington, D.C. office. I have over 30 years of experience in advising financial institutions and payment systems on regulatory and compliance issues. In particular, for purposes of this hearing, I have advised card issuers and payment systems on responding to legal and operational issues involving the use of payment cards for Internet gambling transactions, including the development and implementation of procedures to block such transactions. I also have advised card issuers on questions relating to litigation and other customer disputes arising out of the use of payment cards for Internet gambling transactions. Thank you for the invitation to participate in this hearing.

Internet gambling presents unique challenges for both law enforcement and U.S. payment systems. Because Internet gambling can be conducted entirely over the Internet, transactions can be initiated quickly and quietly—entirely in the privacy of the gambler's own home, or wherever else the gambler has access to the Internet. There is no need to exchange physical cash or illicit goods between the gambler and the gambling operation. Moreover, Internet gambling operations are typically situated at off-shore locations that are beyond the reach of United States law enforcement agencies. Authorities in these foreign locations may consider the Internet gambling operations to be not only profitable, but fully legal under local laws and, therefore, the foreign authorities may have no incentive to shut down these operations. In addition, Internet gambling has proven to be popular for both gamblers and gambling operations. The General Accounting Office ("GAO") has reported that worldwide revenues for Internet gambling in 2003 are

projected to exceed \$5 billion. These factors make Internet gambling uniquely difficult to detect or control.

In part because many Internet gambling operations are physically beyond the reach of jurisdictions where such transactions are illegal, efforts to address the unique and growing problem of illegal Internet gambling have included a focus on the payment systems that often have been used to fund illegal Internet gambling transactions, including the principal payment card Associations—Visa and MasterCard. These Associations are composed of tens of thousands of regulated financial institution members located throughout the world. Banks that are members of these Associations issue credit cards and debit cards to their customers that can be used in person, over the telephone and over the Internet with merchants located throughout the world. Merchants submit proposed transactions to banks that act as acquirers of credit card and debit card transactions for authorization and, if authorized, the transactions are then submitted to the card-issuing bank for payment. The acquiring bank obtains authorization and payment from the issuing bank through the complex, worldwide communications and settlement systems established and maintained by the Associations. These payment systems process billions of transactions originating at tens of millions of merchant locations throughout the world, usually delivering responses on individual transactions in seconds. Because such payment cards are the most efficient consumer payment vehicles in the world, and because payment cards are particularly well suited for Internet and telephone transactions, illegal Internet gambling operations often seek to obtain payment from their customers through the use of payment cards.

However, payment card issuers and the Associations have no interest in having their cards used for illegal transactions. In fact, for example, Visa prohibits the use of Visa branded payment cards for illegal transactions of any kind. Illegal Internet gambling transactions in particular have led to extensive and costly litigation over whether participating cardholders are liable for charges to their accounts, even when the cardholders do not dispute that they participated in the gambling transactions. Even where the illegal Internet gambling transactions do not result in litigation, they often generate severe customer relationship problems with cardholders who otherwise may be model customers. In addition, repayment problems resulting from illegal Internet gambling transactions can adversely affect the ability of cardholders to meet their account obligations generally—including those relating to legal, non-gambling transactions. As a result, illegal Internet gambling transactions create credit risks for financial institutions that extend far beyond the illegal transactions themselves, as well as reputational risks and regulatory responses harmful to both the financial institutions and the payment systems. In short, the costs to the payment card industry in the United States of illegal Internet gambling transactions far exceed any benefits that could possibly be gained by the marginal additional transaction volume due to such transactions.

Consequently, both payment card issuers and the Associations have taken a number of steps in their efforts to address the use of credit cards and debit cards for illegal Internet gambling. The good news is that these steps are having a demonstrable effect on the volume of Internet gambling transactions. According to a December 2002 GAO report on Internet gambling, the card industry's efforts to restrict the use of payment cards for Internet gambling has already had a substantial adverse effect on the

growth and revenues of the Internet gaming industry. The bad news is that, according to this same GAO report, Internet gambling operations are already developing alternative ways to obtain payment for Internet gambling transactions, outside of the payment card systems.

As to the specifics of the payment card industry's efforts to counter illegal Internet gambling, both of the Associations require Internet gaming merchants that accept Association branded payment cards to use a combination of "gaming" merchant category and electronic commerce indicator codes for all Internet gambling transactions when they request authorizations from card issuers for payment card transactions. These codes are transmitted through the networks as part of the authorization message. The combination of codes informs the card issuer that the transaction is likely to be an Internet gambling transaction, thereby enabling the issuer to deny authorization for (or block) such transactions to protect the interests of both the card issuer and its cardholders. Many, if not most, card issuers already have taken advantage of this blocking capability, as well as other tools they have devised to deny authorization to any transaction coded as an Internet gambling transaction. The GAO report described earlier confirms that the blocking efforts of card issuing banks already are having an impact on Internet gambling transactions, and that, according to the GAO, some Internet casino operators now estimate that four out of every five requests for credit card payments are denied.

It is no small undertaking for payment system participants to block Internet gambling transactions even when they can be identified through coding systems; and since the Associations typically process thousands of authorizations per second, both the Associations and card issuers must necessarily rely on such coding systems to identify

illegal Internet gambling transactions. For example, since the Visa system alone currently processes between 3,000 and 6,000 transactions a second, it is operationally impossible to individually recognize, let alone examine, payment card transactions except through their routing, financial and transaction codes. In fact, any effort to individually examine transactions would threaten the entire operation of the payment systems that all U.S. consumers rely on to conduct instantaneous transactions around town, across the country and throughout the world.

Because these systems rely on proper coding by merchants, the blocking may not be complete, for example, if Internet gambling operations miscode authorization messages, despite the aggressive efforts of the Associations to enforce their coding rules. Also, as the GAO has recognized, blocking payment card transactions may lead to the use of other payment methods and, therefore, may not solve the problem of illegal Internet gambling. In addition, given the enormous volume of transactions handled by the payment card systems and card issuers, it is important to recognize that some Internet gambling transactions will evade even the most sophisticated detection and blocking mechanisms. For these reasons, any legislation designed to address illegal Internet gambling by focusing on the responsibilities of payment system participants to identify and block such Internet gambling transactions must recognize that mechanisms for achieving this end will not be infallible and that some transactions inevitably will leak through.

It also is important to recognize that not all Internet gambling transactions are illegal Internet gambling transactions. For example, a cardholder residing in a particular state may engage in gambling transactions at a legal Internet gambling site located in that

same state in a manner where both the gambler and the gambling institution are acting in full compliance with applicable state law; or the cardholder may be purchasing non-gambling items on an online casino's Web site, such as tickets for casino shows. Alternatively, a U.S. cardholder currently visiting, or even residing in, London may engage in gambling transactions through use of a card issued by a U.S. bank at a legal Internet gambling site in the United Kingdom in full compliance with applicable U.K. law. These intrastate and international jurisdictional and choice of law questions present complex and politically sensitive issues, but these are policy issues for Congress, the Administration and their counterparts in the states and in other countries, rather than for payment system participants.

In addition, payment system participants have only a limited ability to differentiate between transactions. In this regard, it is important to recognize that coding mechanisms only inform the payment system and the card issuer that a transaction presented for authorization is likely to be an Internet gambling transaction; it cannot tell the payment system or the card issuer whether the particular transaction is illegal or not. As a result, the application of coding and blocking capabilities by payment systems and/or card issuers will necessarily result in the blocking of many legal, as well as illegal, transactions. In order to ensure that payment systems and individual financial institutions are not exposed to liability for contractual or regulatory violations because they failed to carry out transactions, in some cases fully legal transactions, requested by cardholders, any legislation focusing on the responsibilities of payment system participants to identify and block illegal Internet gambling transactions must provide that those engaged in attempting to block Internet gambling transactions will not be liable, by virtue of those

actions, for violations of any statutory, regulatory or contractual requirements because they have blocked, or attempted to block, any transactions coded as Internet gambling transactions, regardless of whether those transactions actually are gambling transactions or not, and regardless of whether the Internet gambling transactions actually are legal or not. In short, such a legislative safe harbor cannot be limited to blocking illegal Internet gambling transactions, but should extend to all transactions blocked in response to the statute. In addition, because payment systems and card issuers can only block Internet gambling transactions that are identified as such, the legislative safe harbor should extend to transactions which are not blocked, because they are not identified as Internet gambling transactions.

Members of Congress, and other proponents of Internet gambling legislation, have reported that illegal Internet gambling presents significant and unique risks, and payment card issuers themselves have been confronted by significant litigation and unique credit and reputational risks as a result of such transactions. As a result, several card issuers already have expressed support for pending Internet gambling legislation and I would expect card issuers generally to work with Congress to address this issue by blocking Internet gambling transactions. Most major card issuers are already doing so and, as indicated above, as a result of these industry efforts, Internet casino operators estimate that four out of every five requests for credit card payments are already denied.

Again, I appreciate the opportunity to participate in this hearing, and I would be pleased to answer questions from the Committee.