white paper

Merchant Cash Advances

PRESENTED BY THE
RISK & FRAUD
MANAGEMENT COMMITTEE
OF THE ELECTRONIC
TRANSACTIONS
ASSOCIATION

March 2008

ETA

ELECTRONIC TRANSACTIONS ASSOCIATION
2007-2008 RISK & FRAUD
MANAGEMENT COMMITTEE

Laurie LeBoeuf ***(Chair)***
Vice President Operations
Rapid Advance
7316 Wisconsin Ave Ste. 450
Bethesda MD 20814
(240) 482-4690
Laurie@rapidadvance.com

Jeffrey De Petro ***(Vice Chair)***
Vice President
EVO Merchant Services
515 Broadhollow Road
Melville, NY 11747-3709
516-962-7849
jdepetro@goevo.com

Rick Allen
Director of Compliancy
Payment Processing, Inc
8200 Central Avenue
Newark, CA 94560
(510)795-4977
rallen@paypros.com

Cathy Billings
AVP Credit & Fraud Operations
Transfirst
371 Centennial Parkway
Louisville, CO 80027
303-402-8115
cbillings@transfirst.com

Stephanie Cook
Vice President, Risk and Fraud
Metavante Corporation
4900 West Brown Deer Rd
Milwaukee, WI 53223
414-815-7077
Stephanie.cook@metavante.com

Linda Grimm
Senior Vice President,
Director of Operations
Humboldt Merchant Services
PO Box 1479
Eureka, CA 95502
(707)269-3249
lgrimm@hbms.com

Mimi Hart
President & CEO
Magtek
20725 South Annalee Avenue
Carson, CA 90746
310-631-8602
mimi.hart@magtek.com

Richard (Rick) Heroux
President
Cost Savings Reduction Specialists
2671 SW Port St. Lucie Blvd.
Port St. Lucie, FL 34953
772-344-7334 ext. 24
rheroux@csrsi.com

Kevin Lavigne
Vice President, Operations and
Risk Management
Federated Systems
2 Huntington Quadrangle
(3rd Floor North)
Huntington, NY 11747
631-270-7506
k1@fpsemail.com

Chad Nielson
Senior Compliance and Risk Manager
Authorize.net
915 South 500 East
American Fork, UT 84003
801-492-6528
cnielson@Authorize.Net

Mike Petitti
Chief Marketing Officer
AmbironTrustWave
120 N. LaSalle Street Suite 1250
Chicago, IL 60602
(312) 873-7291
mpetitti@atwcorp.com

Deana Rich
Western Regional Director of MAC
Rich Consulting
16622 Gilmore Street
Van Nuys, CA 91406
818-613-7627
deanar@bizla.rr.com

Victoria Strayer
VP, Business Risk, Operations &
Compliance
TSYS Acquiring Solutions
8320 S. Hardy Drive
Tempe, AZ 85284-2007
480-333-7586
victoria.strayer@tsysacquiring.com

Rob Tourt
VP, Network Services
Discover Network
2500 Lake Cook Rd.
Riverwoods, IL 60015
(224) 405-2961
robtourt@discoverfinancial.com

Anthony Urquidez
Director of Operations
Signature Card Services
8360 Melrose Avenue 3rd Floor
Los Angeles, CA 90069
888-334-2284 ext. 225
aurquidez@signaturecard.com

Ginger Bergman /
Hector Rodriguez
Visa USA
800 Metro Center Boulevard
Foster City, CA 94404-2775
gbergman@visa.com
hrodrigu@visa.com

For his contribution to the content of this paper, we also thank:

Joseph Looney
General Counsel
Rapid Advance
7316 Wisconsin Ave Ste. 450
Bethesda MD 20814
(240) 482-4690

TABLE OF CONTENTS

Introduction / Executive Summary 4

1. **The Basics** 5
   a. Understanding What a Merchant Cash Advance is
   b. Typical Product Features and the Mechanics of Repayment
   c. Benefits to the Merchant
   d. Merchants Best Suited for this Product

2. **Legal Considerations** 5-7
   a. Product Definition — Loan vs. Sale
   b. Usury Laws
   c. Collection Issues
   d. Unfair Trade Practices
   e. Other Issues

3. **Questionable Practices in the Marketplace** 7-8
   a. Excessive Retrieval Rates
   b. Additional Funding Obligations ("Stacking")
   c. Acquirer Notification — Funding
   d. Disclosure of Fees and Terms
   e. Additional Considerations

4. **Card Company Operating Regulation Considerations** 8-9
   a. Visa, USA
      i. Background
      ii. Payment system risk
   b. Card Company Rules
      i. Visa, USA
      ii. Discover Network

5. **Risk Management Considerations** 9-11
   a. Due Diligence Standards for Merchant Evaluation (Operational/Subjective Risk)
   b. Assessing a Merchant's Ability to Repay (Financial Risk)
   c. Creating a Workable Retrieval Percentage
   d. Dealing with Merchants Unable to Satisfy Payment Agreements
   e. Ongoing Risk Management Monitoring

ETA Best Practice Principles 12-13

INTRODUCTION / EXECUTIVE SUMMARY

The rapid growth of the merchant cash advance (MCA) marketplace has provided many merchants with an alternative source of funds for business development and provided Independent Sales Organizations (ISOs) with a profitable new revenue stream that can help offset pricing pressures in the hyper-competitive card processing business. While there have been no major reports of any increased risk to acquirers that have partnered to offer MCA programs, this growth has led to reports that some organizations may be engaging in questionable sales practices that threaten to create a reputational risk for the merchant acquiring industry and attract the unwanted attention of federal/state lawmakers and regulators. As such, the ETA Fraud and Risk Committee have developed this paper to explain the MCA industry as well as outline risks that are associated with this product. The MCA process is currently unregulated. To aide in the continued prosperity of this product, the committee has put together a list of best practices that can be found at the end of this White Paper.

SECTION 1 — THE BASICS

Understanding What a Merchant Cash Advance is

A cash advance is a product currently being offered to the small businesses that accept credit card payments. The advance is based off the purchase of future receivables of the credit card sales volume that the merchant is going to process. The uniqueness of the advance is that there are no "set" payments and no set time limits. The repayment is based on the merchants' business volume. This is why it is so important to understand the seasonality and business stability of the merchant along with the current economics.

Typical Product Features and the Mechanics of Repayment

Most companies will fund up to four times the merchant's average monthly card volume, with the average payback amount ranging from 15-25% of the daily merchant processing. The usual time allowed for the repayment is six to eight months. This time frame is dependent upon the seasonality of the merchant's business.

Benefits the to Merchant

The two biggest advantages that the MCA offers the merchant are no personal liability and ease of funding. Most retail store fronts and small businesses accept credit cards as a form of payment. Rather than using their personal credit, personal collateral or personal guarantee to obtain funding, the business owner can sell his future credit card receivables at a discounted price to the MCA companies.

The other main advantage is that the MCA requires minimal effort and there is a quick turn around on obtaining the cash. Most companies only require a signed agreement, processing statements, current lease and a site survey to prove that the business is in existence. The typical time for a customer to receive their funds is 10 business days. Most banks take much longer for an uncollateralized loan.

Although the MCA is not a loan it "feels" very similar to a line of credit. Therefore, if the merchant finds themselves in an emergency situation and they need to replace equipment or purchase more inventory they can request a "renewal." Depending on the company they can usually do this before the advance is paid in full.

Merchants Best Suited for this Product

This mode of financing works best for small to mid-sized companies that don't have collateral or start-ups that haven't developed an established relationship with a bank. This product also fills a need for rapidly-expanding companies who are outgrowing their operating capital.

Not all merchants are good candidates for this type of product. A merchant with very narrow margins and desperate financial needs is not suited for this product. If they do not identify the financial stress they could experience down the road, the MCA will become a financial burden. This is especially true for merchants that process a majority of their sales volume through credit card sales. A seasonal merchant also has a difficult time during his off season meeting the obligations set forth in his contract. The perfect MCA candidate processes the majority of his face-to-face sales, has a healthy ratio of other sales methods to credit cards and has consistent monthly sales.

SECTION 2 — LEGAL CONSIDERATIONS

Before offering a cash advance product to a merchant, there are several legal issues that should be considered. Set forth below is a brief discussion of the relevant legal issues.

Product Definition — Loan vs. Sale

Some cash advance providers intentionally structure the product as a loan while others structure it as a sale. For companies that structure the product as a sale, the provider should be careful to treat the product, in all respects, as a sale.

Financial assets are sold every day. Examples include mortgages, automobile contracts, accounts receivable, etc. The price at which these assets are sold is based on what a buyer is willing to pay for the asset. The cash advance product is similar in that the merchant's credit card transactions are converted into payments right through the credit card processing system, creating an obligation on acquiring banks and their agents to forward the funds associated with the credit card transactions to the merchant. This right to funds is a financial asset that a merchant may sell. Therefore, if properly treated and documented, the cash advance product should be treated like other purchase and sale transactions.

LEGAL CONSIDERATIONS *cont.*

Whether a cash advance is a loan or a sale depends on the intentions of the parties. The mere fact that the signed agreement states that the transaction is a sale, is irrelevant in most states. In order to be a purchase and sale transaction, the cash advance provider must assume some risk other than the typical risk in a loan transaction (risk of non-payment) and must treat the transaction as a sale. Two risks that cash advance providers should assume are the risks that the business will slow down or possibly close. These are risks not present in a loan transaction, which generally includes a set repayment schedule. Because a cash advance is a sale of certain financial assets, the transactions should not include a payback period, have no minimum payments, and charge no fees. These are all facts that support the conclusion that the transaction is a sale and not a loan. However, whether or not a cash advance is a loan is an issue determined by the intent and actions of the parties. Therefore, even if the agreement with the merchant states that the transaction is a sale, has no repayment period, and has no minimum payment, how the cash advance provider actually treats the transaction will be the deciding factor for most courts.

For the cash advance products intentionally structured as loans, the provider should be licensed as a lender in those states that require unsecured commercial lenders to be licensed. While most states do not require a license for unsecured commercial loans, a number of states do require a license. Additionally, for transactions that are structured as loans, the provider must be aware of state usury laws as they will impact the fees that the provider may charge.

Usury Laws

Some argue that the discount paid for the credit card transactions amounts to a usurious effective interest rate. However, applying the law of usury to a true sale is difficult for two reasons. First, usury is a legal term referring to a rate of interest that exceeds the maximum rate permitted under applicable state law. If there is no maximum legal rate, there can be no usury. Many states do not impose a maximum interest rate for business to business transactions. In these states, even if cash advance transactions are re-characterized as loans, there is no risk of a usury violation. Second, in the states with a usury limit on business-to-business transactions, it is impossible to determine at the time of consummation whether a cash advance contract with no set repayment term is usurious. The only way in which to make such a determination is to wait until the transaction is complete and see how long it took for the cash advance provider to collect the funds it purchased. Only then can you divide the dollar amount associated with the discount by the repayment term to calculate an “effective rate of interest.”

For cash advances intentionally structured as loans (or ones re-characterized as loans), usury is the paramount issue to consider. While many states do not set a maximum interest rate for unsecured commercial loans, some states do set a maximum rate. If a transaction exceeds the maximum rate, the penalties associated with a usury violation vary from state to state. In many states, the law requires any interest charges above the maximum rate be returned to the borrower. In other states, the law requires all interest charges in a usurious loan to be returned to the borrower and some states make the entire transaction unenforceable. A handful of states also include a criminal usury cap (e.g. New York). Any person charging interest greater than the criminal usury cap is subject to penalties under the criminal law.

Collection Issues

Another significant legal issue associated with the cash advance product is the collection practices of the cash advance providers. The collection practices can be very intense and in some cases may violate state laws. Examples of collection practices that may violate state laws include making collection calls repeatedly in an attempt to harass the merchant, calling merchants at unreasonable hours, making false allegations when collecting (telling the owner of the business merchant he/she will go to jail for failure to pay). While almost all states regulate consumer collection activities, many also regulate commercial collection activities. The collection practices of cash advance providers are also relevant to the loan versus sale issue. If a cash advance provider collects on an account as if it were a loan (requires catch-up payments when the merchant’s business slows down or requires repayment in full after a set period of time regardless of the merchant’s credit card processing volume), the transaction looks more like a loan than a sale. Thus, collection practices become relevant in determining the intent of the parties and may result in a transaction being re-characterized as a loan.

Unfair Trade Practices

Many states as well as the federal government have statutes or regulations that prohibit unfair and deceptive acts or practices (commonly referred to as "UDAP" laws). The UDAP laws are usually written broadly and permit the appropriate regulator or attorney general to bring an action against a company regardless of whether consumers or businesses are harmed. This is evident by recent UDAP actions brought by various state regulators and the Federal Trade Commission against companies engaged in leasing credit card terminals to small businesses. Cash advance providers should market the product in a manner that accurately describes the product and the merchant's obligations. Practices such as marketing a product with a discount rate for which no merchants qualify (bait and switch), misleading the merchant as to the true nature of the transaction, or harassing a merchant that breaches the cash advance agreement are all practices that are clear UDAP violations.

Other Issues

Cash advance transactions are business to business activities. Therefore, many of the laws that apply to business to consumer transactions do not apply. However, there are still many laws that do apply (e.g. Fair Credit Reporting Act, USA Patriot Act, Uniform Commercial Code, OFAC, etc.). All of these laws impose responsibilities on cash advance providers.

SECTION 3 — QUESTIONABLE PRACTICES IN THE MARKETPLACE

Excessive Retrieval Rates

The cash advance product has a growing presence in the Acquiring industry. With that presence comes the opportunity to provide a service to a section of our industry where the needs are currently not being met. The banking sector has slowly reduced or eliminated the small business loan. They seldom are willing to give the "customer down the street" funding for capital and now limit the loans they are willing to grant to established businesses with collateral for security. It is imperative that we as an industry ensure that companies do not take advantage of the fact that these businesses have limited funding opportunities.

There are companies that are selling the advance for a steep price also known as a "finder's fee." These fees can range from a flat rate to a percentage of the dollars obtained. Although this seems innocuous, if you are a customer and are trying to obtain funding, an additional 10-15% could be charged and reduced from the advance amount. This, as well as the cost of money, could make the advance very unreasonable, thereby causing the merchant more financial hardship.

Additional Funding Obligations (Stacking)

Often if a customer is brought to an MCA by a Cash Broker (a sales agent who receives a commission for the sale and nothing else) there is a possibility that the merchant is being shopped around, similar to the mortgage brokers when they are trying to find the best interest rates. The concern with this practice is that if a merchant only receives a portion of the amount of cash that he needs he may be tempted to accept more than one offer. Or, he may accept one offer and then apply for additional advances. This is known as "stacking" cash advances. As these advances are paid off via a percentage of all the credit card transactions, a merchant with more than one advance being paid off at the same time could potentially deplete his cash flow. If there is a default on the agreement, the advance company that has first rights or a UCC filed, will probably be the only MCA able to collect. It is prudent for the underwriting departments of cash MCAs to research the merchant to avoid "stacking." One such way would be very similar to the ACQ inquiries on the credit reports for merchant processing accounts. If an underwriter notices a cash advance company listed on the merchant's credit bureau inquiry (seen as an "MCA" suffix behind the company name in the inquiry section), the merchant should be further investigated.

Several of the cash advance companies will "pay off" a merchant's existing cash advance with another company in order to eliminate the possibility of stacking. It should also be clearly defined in your agreement that your customer may only have one advance at a time.

Acquirer Notification — Funding

There are several ways that cash advance companies can collect their "split" or percentage of the credit card processing during the term of the agreement. The safest way is to establish a relationship with a

QUESTIONABLE PRACTICES IN THE MARKETPLACE *cont.*

"processing partner" and have the monies withheld from the daily funding of the merchant's processing. Another way is to receive a daily transaction file from the processor and send an ACH debit item to the merchant's Demand Deposit Account. This way is less desirable due to the potential of the funds not being available when the debit is processed. The first solution not only protects the cash advance company by building a rapport in the case of diverted funds or questionable activity, but it also alerts the acquirer to potential financial stress for the merchant. Although this does not indicate a risk to the acquiring industry it may assist in the monitoring of chargeback activity and or risk monitoring. Please note that all Association rules must be adhered to in the MCA process.

Disclosure of Fees and Terms

It is very important that a customer understand the terms of the agreement that they are agreeing to. Oftentimes, the merchant is only seeing that he is able to get funding and doesn't actually understand that a percentage of his credit card sales are going to be withheld daily, or he hasn't actually calculated the complete amount he will be paying for the money. An efficient manner in which to educate the merchant is to complete a "pre-funding" call with the merchant. This gives the company the opportunity to go over the amount of funds being dispersed, the amount of money expected to be paid and the percentage of the daily sales that are going to be required to meet the obligations in the time specified.

Additional Considerations

When establishing an MCA relationship and mapping out the details of the process, ensure that all applicable compliance rules are considered. This may not be limited to just each individual card brand, but could also include NACHA, OCC, etc. Each program is unique; therefore those rules are not covered here. However, as with any program, approaching the design and operational support in a comprehensive manner will help ensure your compliance risk is protected.

SECTION 4 — CARD COMPANY OPERATING REGULATION CONSIDERATIONS

VISA, USA

Background

In the basic framework of the four-party payments system, Visa has direct relationships with issuing and acquiring financial institutions, while issuing banks have direct relationships with cardholders and acquiring banks have direct relationships with merchants. Visa is not a party to the relationships issuers have with cardholders and the relationships acquirers have with merchants. These financial institutions are accountable to Visa for ensuring compliance with all rules promulgated to facilitate the smooth, efficient and safe operation of the payment system. These rules extend to the governance of merchant settlement funding.

Payment System Risk

Visa has developed extensive risk models used to assess the financial strength of each financial institution. The acquiring models include but are not limited to, the monitoring of each financial institution's Tier 1 capital, loan losses and reserves, the amount of chargebacks processed, settlement volumes and high risk volume. As Visa does not have visibility in merchant funding advances, any diversion of settlement funds from the merchant to another entity can significantly alter an acquirer's risk ratings, resulting in under-valuing the risk of the business. In the most extreme case, it could result in the failure of the financial institution and payment system losses.

Visa's right to control merchant settlement does not extend beyond the point at which the funds reach the account of record for the merchant. Entities that extend funds against a merchant's future payment system deposits may access the proceeds of the merchant settlement funds after the point at which it has been deposited into the account on file for the merchant at the acquirer.

CARD COMPANY RULES

Visa, USA

Acquiring financial institutions that participate in the payment system are financially liable to Visa for all activity that passes through the ICAs and BINs for which they are the licensee. This includes but is not limited to, funds derived from merchant processing and settlement activities. Visa rules require the acquirer to provide settlement directly to the merchant. This statement has been interpreted to mean that all settlement funds that are due and payable to the merchant, less any fees, chargebacks or other essential holdbacks, must be directly funded to the account on file for the merchant. The splitting or diversion settlement funds to an entity other than the merchant are not permitted. This includes the use of multiple deposit accounts for the merchant, the use of trustee accounts and/or other similar scenarios that do not result in the direct funding and available usage of these funds by the merchant.

Discover Network

Considerations

Discover is generally unaware that its merchants are party to such agreements. Discover considers such cash advances in exchange for payment through credit card receivables as an indicator of incremental risk which may result in default, financial instability, formal or informal reorganization or liquidation. In that such cash advances are not obtained from a recognized financial institution, it is likely that the merchant is unable to obtain the necessary credit to be eligible for a traditional credit facility or loan. Discover is unable to be assured that the settlement bank account would have available funds for debits associated with chargebacks, returns, adjustments or fees.

High Level Requirements

In the event that Discover is made aware that its merchant is party to an agreement with a cash advance arrangement, a risk analysis using the established proprietary methodology is completed. The fee frequency should be established to be taken on a daily basis. All settlement, offsets, adjustments, returns, chargebacks, and fees should be netted prior to depositing into the settlement account. The fraud team should be alerted and regular monitoring should be established. The financial risk team should be alerted and regular monitoring should be established. The data security team should be alerted with respect to possible data compromise potential in the event that the cash advance company has access to merchant's customer records.

Contractual Considerations

The Merchant Services Agreement and Operating Regulations should consistently establish a requirement that Discover maintain its rights to all chargebacks, returns, adjustments and fees prior to depositing settlement funds into the established bank account. Establish a process in which the merchant is required to obtain Discover's explicit permission to deposit funds into a bank account that is not in the legal name that the Merchant Services Agreement is in. Maintain the right, in the event that a bank account rejects debits, that the merchant is obligated to provide alternate banking within a defined period of time (suggested 3 business days). Establish requirements in the Merchant Services Agreement and Operating Regulations requiring a merchant to notify Discover in the event that settlement funds are being directed to a third party.

MasterCard Worldwide

provided no comment for this paper

American Express

provided no comment for this paper

SECTION 5 — RISK MANAGEMENT CONSIDERATIONS

Risk Management considerations encompass both due diligence standards of review and approval as well as ongoing risk management and monitoring to manage liability.

Due Diligence Standards for Merchant Evaluation (Operational/Subjective Risk)

The first step in the merchant evaluation process is to ensure you have well developed and well implemented due diligence standards (aka underwriting policies). The due diligence standards should continually be reviewed to ensure the standards evolve with the industry, track trends and address liability.

RISK MANAGEMENT CONSIDERATIONS *cont.*

The application of the due diligence standards should be applied to each merchant's request for funding. Funding companies should follow similar standards and then apply further subjective review should a request not fit within the standard guidelines.

When a merchant applies for a cash advance the funding company should follow strict guidelines for underwriting and approval. Underwriting guidelines should be based on a review of the business, principals and financials.

Business Review:

1. A minimum number of years in business
2. A minimum timeframe of existing processing of credit cards in which to assess the history of the merchant's processing
3. Adequate legal business formation
4. Set standards of minimums and maximums for advance amounts
5. Set standards of minimums and maximums for transactions types (i.e., swipe vs. MOTO vs. E-Commerce)

Principal Review:

1. A minimum number of years of the principal's ownership of the business
2. Clean criminal record
3. Majority ownership signing
4. Set minimum credit bureau FICO scores and derogatory reporting

Financial Review:

1. Review of financial statements for both the business and principals
2. Review a minimum of 3 to 6 months prior processing statements to adequately assess processing volumes and activity
3. Good standing with other creditors and vendors (premise lease, etc)
4. Development of maximum repayment percentage and payback timeframe to ensure no adverse effect to the merchants cash flow ability to continue business
5. Develop maximum standards of review and above the standard set additional requirements such as an onsite visit
6. Set minimum for eligibility for re-funding upon repayment of X% of repayment from previous advance

Assessing a Merchant's Ability to Repay (Financial Risk)

During the underwriting phase, the assessment of the merchant's ability to repay the advance funding is a key factor in determining the decision if it will be funded and how much will be funded. Knowing the purpose of the funding helps in the final determination. Not only should the financial standing of the company and principals be taken into consideration, but also the product or service provided by the merchant.

If a product or service is provided that does not have growth potential, that must be taken into advisement. Additionally, if the product is high risk or has the ability to have high chargebacks or returns, then the merchant may not be around long due to his payback of his capital to refunds and chargebacks, and ultimately go out of business due to the product or service not having much of a successful future. Knowing the margin and growth of the business will assist to effectively estimate the repayment percentage. Not going above the margin reduces the risk of putting the merchant out of business.

Verify that the merchant has no other funding obligations with other providers. Verify that they do not split their processing between multiple acquirers. If there is an existing funding, work to manage the repayment of the first prior to creating another funding. If the existing funding is from another provider, then take into account this consolidation of the funding. These same standards should apply to any renewals of the cash advance by the merchant over time. Many times a merchant finds that the cash advance works well for his business model, so he will utilize this process for funding future business needs.

Creating a Workable Retrieval Percentage

Ensuring that a merchant has adequate capital to continue to operate unimpeded is the most important consideration. If the merchant is unable to continue to operate their business with the reduced revenue due to the funding split, then not only will the funding become a loss, but also the credit card processing account may also be subject to loss as the merchant may not be able to fulfill their products or service due to the lack of adequate capital. Therefore, creating a workable repayment is key in the repayment of the fund and longevity of the merchant.

Know what the funds are to be used for to help determine the longevity of the fund as well as repayment. For example, will it be used for remodeling so the restaurant may be closed for some time, for a vacation, to pay down some debt to increase cash flow, or to buy new equipment? Each reason for the necessity of funds may cause a different outcome.

Dealing with Merchants Unable to Satisfy Payment Agreements

The risk associated with a merchant's inability to repay the funding, and the cascading effects such as the credit card processing potential losses, etc. is paramount in the success of the funding company as well as the success of the acquirer. Simply put, complete repayment must be the ultimate outcome. Unfortunately merchants go out of business, sell their business or are simply unscrupulous, which leads to losses. Hopefully, a loss can be avoided by working closely with the merchant and acquirer to track performance. If a merchant begins to struggle to stay afloat due to the reduced daily capital, then the funding company and acquirer should be in communication so that they can work together to help the merchant to ultimately avoid losses for all.

If a merchant simply can't afford to pay the repayment percentage, then a reanalysis is needed to reduce the repayment amount. If a merchant begins to struggle to fulfill product or service, then the cascading effect is inevitable. ISOs and acquirers carry this burden today and with a funding, this liability is compounded. Therefore, monitoring merchants with funding by the funding providers as well as the acquirers is needed for the ongoing management of liability. When either group begins to see the signs and patterns, then communication is needed to restructure the funding to ensure neither side is left with a loss. Under standard processing agreements, acquirers must ensure full and first rights to all funds processed by the merchant should there be a default on the merchant account.

If a merchant does go bad, standard collection practices should be followed, per state and federal regulations. To the extent allowed, the funding company should report the loss to the credit bureaus so that any other funding company or acquirer can see the loss and take this into consideration when reviewing a new application for funding or credit card processing.

A negative reporting to the industry (MATCH-like) should also be explored.

Whether or not a principal's personal guarantee is allowed, dependant upon usury laws, there should be considerations and warranties on a fraud level for misrepresentation of data if they go out of business and are unable to repay. Therefore, to the extent possible, there should be some liability personally if there is misrepresentation of data, if the merchant sells the business prior to satisfying their repayment obligation, if the merchant blocks ACHs or changes their direct deposit account, preventing their repayment obligations from occurring.

Ongoing Risk Management Monitoring

As stated earlier, ongoing risk management monitoring is key in the continued success of the funding company, acquirer and merchant. Risk management departments at both companies should be in contact with each other and should correspond regarding events, issues, etc. for the merchants they share. By applying standard risk monitoring tools, patterns and signs can be spotted that will lend to the identification that a merchant has either gone bad or is struggling and about to go bad. This is the point at which both companies should step in to work with the merchant, as it is in both of their best interests. In most cases, when an acquirer must act to protect their liability, they will divert funds to create a reserve to cover any potential loss. This unfortunately impacts the funding provider as now they are not obtaining their split of the processing which in turn increases their liability. If the two sides are not in communication, they risk causing losses to each other due to each side's individual dealings with the merchant.

Tender Shifting is another risk. Tender shifting occurs when the merchants ask the cardholders to use American Express instead of Visa and/or MasterCard so the deposit of funds is not affected by the repayment split. If the MCA and acquirer work together to monitor volumes they can help prevent tender shifting.

ETA BEST PRACTICE PRINCIPALS

SUMMARY

The Merchant Cash Advance (MCA) is a product currently being offered to small businesses that accept credit card payments. The cash is advanced to purchase the future credit card receivables that the merchant is expected to process. The rapid growth of the MCA marketplace has provided many merchants with an alternative source of funds for business development and provided Independent Sales Organizations (ISOs) with a profitable new revenue stream that can help offset pricing pressures in the hyper-competitive card processing business. While there have been no major reports of increased losses to acquirers that have partnered to offer MCA programs, this growth has led to reports that some organizations may be engaging in questionable sales practices that threaten to create a reputational risk for the merchant acquiring industry and attract the unwanted attention of federal/state lawmakers and regulators. Consistent with the principles established in ETA's Code of Conduct, the ETA has established a set of "best practices" that set forth a framework for acquirers/ISOs to assess the business practices of the MCA companies ("MCACs") they select as vendors or with whom they otherwise have relationships. Following these practices will foster ethical behavior and lead to further industry success and continued growth.

MERCHANT CASH ADVANCE BEST PRACTICES – *Part I*

When selecting an MCAC, acquirers/ISOs should confirm that the MCAC adheres to the following practices/guidelines:

Cash Advance Repayment Criteria Must Be Fair and Sustainable

Due to a variety of factors, merchants that apply for a cash advance based on payment processing are often not able to obtain funds from traditional methods (e.g., bank lending, corporate financing, etc.). As such, it is important for the sake of the viability of the merchant that the retrieval percentage be fixed and set at a reasonable level to ensure the merchant is able to maintain an appropriate and predictable cash flow to operate his/her business. Careful attention should be given in the underwriting process to the merchant's processing history, business plan (including proposed use of funds), cash flow position (including the cash flow once payments are being made), profit margins, and the overall health of the business prior to establishing the retrieval percentage.

Disclosure of Terms/Conditions and Marketing Materials Must Accurately Present Product

All marketing materials and contractual documents for an MCA should represent the terms/conditions of the product accurately and all the principles involved in the product offering to the merchant. Contracts should clearly and conspicuously disclose:

- The name of the funding source
- The actual repayment/pay-back percentage
- The purchase price paid
- The value of the receivables sold
- Disclosure of all fees

Additionally, when marketing the product, the criteria for qualification should be clearly and conspicuously disclosed. Any change in the terms/conditions of an existing MCA must be evidenced by the written consent of the merchant.

Avoid Merchants with High Chargeback Levels

The majority of MCAs are given to face-to-face merchants where only a minimal number of chargebacks should be found on the processing statements reviewed. Chargebacks should NOT be the normal course of business of a merchant receiving an MCA, as merchants with a high level of chargebacks represent a risk to the integrity of the payments system.

Existing Cash Advances

Most MCA contracts require merchants to disclose outstanding obligations; however, some merchants may knowingly misrepresent the existence of obligations in order to obtain additional funding that can create a risk to the system. This issue is further complicated by the fact that MCAC inquiries may not be readily apparent on a credit report as they are not a specifically identified business category to the credit bureaus (pursuant to applicable law, MCACs do not generally report advances to the credit bureaus because most do not involve a personal guarantee). To the extent an MCA provider obtains consumer credit reports, procedures should be in place to identify an inquiry as one from an MCAC where possible.

Limit Multiple Advances to a Single Merchant

In order to effectively manage risk and prevent a merchant from becoming over-extended, merchants should not knowingly be allowed to "stack" advances (obtaining an additional advance when an outstanding balance on a previous advance exists). In the event additional advances are sought, the original advance should be paid off directly to the previous MCAC by the new MCAC (to ensure that the merchant does not retain funds due to the previous MCAC) with a portion of the proceeds given on the current advance.

Ongoing Due Diligence and Review of Merchant Activity

MCACs should diligently monitor the processing volumes of their merchants on an ongoing basis to identify any significant changes (increase or decrease) that could indicate an issue with a merchant and investigate any such changes.

Merchant Education and Customer Service Principles

The MCAC must have practices and procedures in place to ensure the merchant understands the terms of the advance. Additionally, the MCAC should establish a responsive service level requirement for customer service (e.g., inquiries responded to within 24 hours, live-customer support, etc.) to provide ongoing support to the merchant and strengthen the processing system.

Merchant Cash Advance Companies Must Be PCI Compliant

For MCACs that handle sensitive payment related information subject to the Payment Card Industry Data Security Standards, the MCAC must fully comply with the Standards.

MERCHANT CASH ADVANCE BEST PRACTICES – *Part II*

When performing services on behalf of MCACs, acquirers/ISOs should adhere to the following practices/guidelines:

Merchant Payment of Cash Advances Must Adhere to Applicable Regulations

In order to preserve the accounting integrity of the card payment system, any repayment processes established by acquirers/ISOs to forward funds to MCACs must comply with all applicable operating regulations and guidelines issued by the payment networks (i.e. direct pay and other funding issues). Acquirers/ISOs are expected to clearly and conspicuously disclose to merchants the procedures established for repayment, or verify that the MCAC is doing so.

Information Sharing

Acquirers/ISOs and MCACs should work together to create a process to identify merchants that have fraudulently obtained cash advances to avoid harming the processing system. Additionally, acquirers/ISOs should to the fullest extent practicable work together to coordinate ongoing risk monitoring of the merchant as well as ensure that an adequate level of customer support and awareness is provided to the merchant.

ELECTRONIC TRANSACTIONS ASSOCIATION
1101 16th Street, N.W.
Suite 402
Washington, DC 20036
(202) 828-2635
(800) 695-5509 Toll-free
(202) 828-2639 Fax
www.electran.org