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Rockville, MD 20852

Re: Docket No. FDA-2011-N-0467
RIN 0910-AG43
Non-Face-to-Face Sale and Distribution of Tobacco Products and
Advertising, Promotion and Marketing of Tobacco Products

We appreciate this opportunity to provide comments on behalf of the National Association of Attorneys General ("NAAG") Tobacco Committee in response to the Food and Drug Administration's advance notice of proposed rulemaking ("ANPR") on the non-face-to-face sale and distribution of tobacco products (also referred to herein as "direct sales" and "remote sales") and the advertising, promotion, and marketing of tobacco products.

INTRODUCTION

On December 9, 2009, the NAAG Tobacco Committee submitted comments to the FDA regarding the implementation of the Family Smoking Prevention and Tobacco Control Act ("Tobacco Control Act"). In those comments, we noted that Internet sales of tobacco products have been a significant source of sales to minors, largely because of a lack of effective age verification by most Internet sellers, and that Internet sales have also been a substantial means of tax evasion, including evasion of state excise taxes. This tax evasion has public health consequences because the non-payment of excise taxes results in lower retail tobacco prices, which in turn cause increased demand for tobacco products. Our comments suggested that action at the federal level would more effectively address these issues than a state-by-state approach, which faces jurisdictional limitations and cannot achieve uniform nation-wide results.

Since we submitted those comments, the enactment of the Prevent All Cigarette Trafficking Act ("PACT Act") in March of 2010 has provided significant new tools for addressing the sale and distribution of cigarettes and smokeless tobacco via the Internet, e-mail, telephone, direct mail, or other non-face-to-face means (referred to in the PACT Act as "remote sales"). At present, however, an important portion of the PACT Act is unenforceable

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because of an injunction entered by the United States District Court for the Western District of New York against the Act's provisions requiring that a "delivery seller" (*i.e.*, a person who makes a remote sale), before selling or delivering cigarettes or smokeless tobacco, comply with laws regarding excise taxes and licensing and similar requirements that are imposed by the state or locality into which the delivery is made. Moreover, as discussed in more detail below, some of the PACT Act's provisions have not operated as effectively as we believe Congress intended, and the Act is limited in its effect to cigarettes, roll-your-own (RYO) tobacco and smokeless tobacco, and does not apply to other tobacco products.

Our comments below cover several topics raised in the FDA's advance notice of proposed rulemaking. First, we recount the states' prior efforts to address the problem of Internet sales of tobacco products in violation of state laws. Second, we list and summarize the various state laws regarding non-face-to-face sales and the policies underlying those laws. Third, we discuss age and identity verification methods, including the results of a study that NAAG commissioned to test the effectiveness of age and identity verification methods used on the promotional websites of certain major tobacco companies. Fourth, we describe how states have attempted to address payment methods being employed to facilitate non-face-to-face sales of tobacco products. Finally, we comment on the implementation of the PACT Act, including ways in which it could be improved.

The basic conclusion we wish to convey in our comments is that, despite the enactment of the PACT Act, the existing legal framework with respect to non-face-to-face sales is not adequately protecting the public health. The reason for this conclusion is that, as discussed in more detail below, the promotion and sale of tobacco products through non-face-to-face sales continue to take place without adequate age and identity verification; such sales continue to evade state tax laws; and states' efforts to enforce their laws continue to be frustrated by jurisdictional limitations and the ability of direct sellers to put up new websites even if a state successfully enforces its law against such sellers.

Where information provided below is responsive to a particular question included in the ANPR, that question is identified. Some of the information or comments are more general or contextual in nature. Moreover, there are suggestions under several headings that respond to Question 10 concerning how the FDA can most effectively partner with other Federal agencies and with states.

I. STATES' EFFORTS TO ADDRESS ILLEGAL INTERNET SALES OF TOBACCO PRODUCTS

State Attorneys General have been actively engaged on the subject of Internet sales of tobacco products for more than a decade. As the Internet became a significant channel for the promotion and sale of tobacco products during the 1990s, states became aware that such sales were violating a number of state statutory and regulatory provisions, including those described in Part II of this submission imposing licensing, registration, age and identity verification, and state tax requirements, as well as laws in some states banning such sales entirely. Because suing individual Internet sellers for violations of state laws proved to be an inefficient method for dealing with the problems of youth access and tax evasion caused by Internet sales, state Attorneys General sought to remedy this situation by focusing on three aspects of Internet sales: (1) payment; (2) delivery; and (3) supply.

As part of this strategy, in March 2005, NAAG convened a meeting in Washington attended by state Attorneys General; the federal Bureau of Alcohol, Tobacco and Firearms; major credit card companies; and major carriers, including the U.S. Postal Service ("USPS"). As a result of that meeting, the credit card companies issued policies against the use of their cards to facilitate illegal Internet cigarette sales unless the seller can establish that it is complying with applicable laws regarding such sales. *See* Appendix 1. Additionally, the major common carriers entered into Assurances of Voluntary Compliance with New York (applicable on a national level) by which they agreed to cease deliveries of cigarettes to consumers in the United States. *See* Appendix 2. Finally, Philip Morris USA Inc. and Lorillard Tobacco Company agreed to protocols designed to cut off access to their cigarettes by any direct buying customer (*i.e.*, distributor) or retailer of those cigarettes that is engaging in remote sales in violation of state law. *See* Appendix 3. All of these agreements apply to cigarettes but not to other types of tobacco products.

These measures were only partially successful, however, with the result that large volumes of cigarettes and other tobacco products continued to be sold through non-face-to-face transactions. First, as described more fully in Part IV below, although the volume of use of credit cards as a means of payment for remote sales of cigarettes was significantly reduced, Internet and other direct sellers switched to electronic payment processing through the Automated Clearing House (ACH) Network, moneygrams, gift cards, demand drafts, and other forms of payment not involving credit cards. Second, while the major private carriers agreed not to deliver cigarettes, the USPS did not agree to do so, citing statutory provisions that it said made such an agreement legally impossible. Large volumes of cigarettes were shipped by remote sellers via the USPS to direct purchasers, and other sellers were able to make alternative transportation arrangements. Finally, the protocols with Philip Morris and Lorillard proved ineffective because

of the difficulty of ascertaining which of their direct buying customers or retailers was the source of the cigarettes in a particular remote sale.

Because it was plain that only a uniform national-level legislative approach to non-face-to-face sales would be effective, state Attorneys General supported enactment of federal legislation. On September 5, 2003, October 24, 2007, and again on March 9, 2010, fifty-one Attorneys General wrote letters supporting enactment of the PACT Act. *See* Appendix 4. As the March 9, 2010 letter stated:

The need for federal regulation is imperative. The states have tried to stop these sales in a number of ways, but despite these efforts, have been unable to fully address the problem on a state-by-state basis. The tools contained in this legislation would significantly strengthen the ability of law enforcement, at both the state and federal levels, to put an end to illegal online sales of tobacco products which evade taxes, a necessary revenue source for many states, are suspected to be linked to terrorist operations, and, most disturbingly, place tobacco products in the hands of children.

The PACT Act was signed into law on March 31, 2010. Its implementation to date is discussed in Part V below.

II. STATE STATUTES RELATING TO REMOTE SALES OF TOBACCO PRODUCTS

States have enacted a variety of statutes relating to remote sales of tobacco products. A list of such statutes, with a brief description of their principal features, is at Appendix 5. Documents from the legislative history of the Maryland and New York statutes, which ban direct sales, are at Appendix 6. The statutes fall into the following general categories; some statutes include more than one category:

- Bans on direct sales¹
- Age and identity verification
 - at purchase
 - at delivery
- Confirmation of purchase by notice to purchaser
- Labeling requirements
- Packaging requirements

¹ At least eight states have such bans: Arkansas, Connecticut, Maryland, New York, Ohio, Utah, Vermont, and Washington.

- Licensing requirements
- Reporting requirements
- Compliance with excise tax collection and remittance
- Notice to purchaser of excise tax payment obligation

III. AGE AND IDENTITY VERIFICATION

As explained in response to question 5 below, current technologies and methods do not effectively prevent the purchase of tobacco products by underage persons in non-face-to-face sales. Consequently, a ban on such sales may be the only way to prevent them.

At the same time, as discussed in response to question 13 below, to the extent tobacco companies are using age verification technologies that make it more difficult for minors to access tobacco company brand promotional websites, such steps should be encouraged. To the extent that tobacco companies are placing tobacco advertisements and promotions on other digital or online venues, the FDA should consider enforcing digital ad placement standards to prevent over-exposing youth in relation to their presence in the U.S. population, while still allowing access by legal age adults.

QUESTION 5. What are the current technologies, procedures or other methods used to ensure that the purchaser of a tobacco product through a non-face-to-face exchange is an adult, including age and ID verification?

Except where non-face-to-face tobacco sales have been prohibited by state law, the PACT Act requires a combination of age verification technologies and procedures to prevent sales to minors during both the sales transaction and delivery. During the sales transaction, the Act requires that the seller obtain the purchaser's full name, birth date, and residential address and verify such information "through the use of a commercially available database or aggregate of databases, consisting primarily of data from government sources, that are regularly used by government and businesses for the purpose of age and identity verification and authentication." 15 U.S.C. § 376a(b)(4)(A)(iii).

During the delivery, the PACT Act requires that the seller include on the same surface of the package as the delivery address a clear and conspicuous statement that the package contains cigarettes or smokeless tobacco. Moreover, the PACT Act requires that the seller use a method of mailing or shipping that requires

- (I) the purchaser placing the delivery sale order, or an adult who is at least the minimum age required for the legal sale or purchase of tobacco products, as determined by the applicable law at the place of delivery, to sign to accept delivery of the shipping container at the delivery address; and

(II) the person who signs to accept delivery of the shipping container to provide proof, in the form of a valid, government-issued identification bearing a photograph of the individual, that the person is at least the minimum age required for the legal sale or purchase of tobacco products, as determined by the applicable law at the place of delivery

Id. § 376a(b)(4)(A)(ii).

The comments filed in this docket by Rebecca S. Williams, Kurt M. Ribisl, and Catherine Jo of the University of North Carolina (“Williams Comments”) provide a summary of the range of age and ID verification methods used by online retailers. Based on a survey of the 200 most popular Internet sellers of cigarettes, the Williams Comments identify six general categories of age and/or ID verification strategies:

1. False claims of age verification;
2. Self-verification (or age affirmation);
3. Online age verification by comparing data from driver’s license or other ID against government databases;
4. Visual Inspection of image of ID (such as drivers license) submitted by customer;
5. Age verification via photo ID at delivery; and
6. Challenge questions posed by third-party age/ID verification services.

As noted in the Williams Comments, several of the above categories may be used in combination, such as requiring that the consumer produce a photo ID at the time of delivery in addition to the steps taken during the online purchase transaction.

Additional information about non-face-to-face age and identity technologies and methods, including biometric solutions, is available in *Enhancing Child Safety & Online Technologies: Final Report of the Internet Safety Technical Task Force to the Multi-State Working Group on Social Networking of State Attorneys General of the United States* (December 31, 2008) which was prepared under the direction of the Berkman Center for Internet & Society at Harvard University, pursuant to the Statement of Principles entered into by the State Attorneys General and MySpace in January 2008. The Task Force was charged with “finding and developing online identity authentication tools” as well as establishing specific and objective criteria that will be utilized to evaluate existing and new technology safety solutions.” The report, which is discussed in more detail below, is available at http://cyber.law.harvard.edu/sites/cyber.law.harvard.edu/files/ISTTF_Final_Report.pdf.

a. How effective are these methods at preventing minors' access to tobacco products through a non-face-to-face exchange?

In responding to this question, we are mindful of the federal district court's extensive discussion of age and identity verification technologies in *ACLU v. Gonzales*, 478 F. Supp. 2d 775 (2007), *aff'd sub nom. ACLU v. Mukasey*, 534 F.3d 181 (3d Cir. 2008), *cert. denied*, 555 U.S. 1137 (2009), where the Court held the Child Online Protection Act (COPA) to be an unconstitutional restriction on free speech. Although the Court reviewed these technologies for their effectiveness in limiting inappropriate contact between children and adults as well as in preventing access by minors to inappropriate content, and not to their effectiveness in preventing access to products through online purchases, the Court's conclusion is equally relevant here. As recounted by the Third Circuit, the District Court found that, "There is no evidence of age verification services or products available on the market to owners of websites that actually reliably establish or verify the age of Internet users. Nor is there evidence of such services or products that can effectively prevent access to Web pages by a minor." 534 F.3d at 196 (quoting *ACLU v. Gonzales*, 478 F. Supp. 2d at 800).

The December 2008 Final Report issued by the Internet Safety and Technical Task Force pursuant to the Statement of Principles executed by the State Attorneys General and MySpace noted that certain available technologies made it more difficult for minors to pretend to be adults, especially adults to whom they are not related or acquainted. Report at p. 8. However, the Report also noted that many of the available technologies result in the user receiving digital credentials after verification that can be used across sessions without re-verifying. Report at p. 9. "These credentials, which are usually protected only by a user name and password, are easy to transfer from adult to child . . . and can be sold, traded cooperatively, or taken under duress." *Id.* While remaining "optimistic about the development of technologies to enhance protections for minors online," the Task Force's conclusion about the overall ineffectiveness of age and identity technology echoed the federal district court's opinion in *ACLU v. Gonzales*: "Age verification and identity authentication technologies are appealing in concept but challenged in terms of effectiveness. Any system that relies on remote verification of information has potential for inaccuracies. For example, on the user side, it is never certain that the person attempting to verify an identity is using their own actual identity or someone else's." Report at p. 10.

Although it is reasonable to assume that age and ID verification technologies have advanced since 2008, we are not aware of any study that refutes the above finding.

Moreover, with regard to methods and technologies currently in use by Internet sellers of tobacco products, the Williams Comments document the shortcomings. Minors can bypass the first four categories listed above merely by typing in a false birth date or by obtaining and using the information from the ID of a parent or other adult. With regard to age verification at delivery,

this strategy would work if retailers actually and reliably paid for such service. Unfortunately, as reported in the Williams Comments, some vendors state on their website that they require age restricted delivery but do not actually do so.

With regard to challenge questions posed by third-party age and ID verification services, the Williams Comments indicate that there are no known studies that have assessed the use or effectiveness of this method.

In this regard, however, the Williams Comments reported on the results of a study conducted by the authors to test the ease with which minors could bypass the online age verification strategies used on certain tobacco company brand promotional (not retail) websites.² Of particular interest, youth participants in the study were able to gain access to R.J. Reynolds Tobacco Company's marketing websites in 42% of their attempts. By using fake Social Security numbers, made-up identities or information from driver's license images obtained through Google, the youth were able to gain access to the websites. As noted in the study, "The fact that made up or unverifiable information resulted in successfully accessing the websites in 42% of attempts indicates that it was unlikely that the submitted information was being verified against government databases. Williams Comments at 8. On the other hand, the Williams Comments indicate that the online age verification used by Phillip Morris USA Inc. and by Lorillard Tobacco Company, which required that the consumer submit their driver's license number, were the most effective in preventing youth access in the study. However, neither the websites nor the Williams Comments provide details on the type of age verification system used by these two companies at the time of the study."³

It would appear that if all else fails, age verification upon delivery would be the most effective way to prevent the ultimate access by youth to cigarettes that had been purchased in a non-face-to-face transaction. However, the Williams Comments also include the authors' findings from a recent study in which 18- to 20-year-olds bought alcohol from 100 online alcohol retailers using only their own real IDs. Williams Comments at 9. "Many packages in the study were delivered by UPS or FedEx and marked as age verification required at delivery, but the effectiveness of this sort of age verification at blocking youth access seemed to vary widely depending on the delivery drivers," with some drivers diligently checking IDs and refusing delivery, "many" leaving the packages at the door without any face-to-face interaction, and others handing the package to the youth without asking for ID or being given the real underage ID. *Id.* Moreover, it is difficult for law enforcement authorities to monitor whether verification is in fact taking place at delivery, and therefore such a requirement is difficult to enforce. In sum,

² This study, which is being submitted with the Williams Comments, was commissioned by NAAG.

³ Attached at Appendix 7 are 2007 and 2008 letters from these companies describing age verification technologies and procedures in use for brand promotional (not retail) websites at that time.

absent improved enforcement of delivery restrictions, a retailer's promise of age verification upon delivery provides only a false sense of security.

- b. If these methods are not effective, which other technologies, procedures, or methods would work more effectively to prevent minors' access to tobacco products through a non-face-to-face exchange?**

The responses provided above, and the Williams Comments, underscore the need for further, independent, and rigorous study of age and ID verification systems and their efficacy. Unless such systems pass the challenges that tech-savvy youth can pose, a complete ban on non-face-to-face sales of tobacco products may be the only way to prevent such sales from resulting in youth access to such products.

- c. Is requiring an adult (whether or not the person who placed the order) to sign for the delivery of tobacco products adequate to ensure that tobacco product purchased through non-face-to-face exchange are not delivered to minors? Or, is it necessary to require that the products be delivered only to the person who ordered them? Are there other requirements that could be placed on the delivery of tobacco products to prevent their delivery to minors?**

As noted above, age and ID verification at delivery is effective only when used. Requiring the adult who placed the order to show ID to receive the package would appear to reduce the likelihood of the cigarettes falling into the hands of a minor. We are also aware that at least one state requires that the retailer call the purchaser in the evening (when parents are more likely to be home) to confirm the order prior to shipment, but we do not have data to determine the efficacy of this additional measure.

QUESTION 13. What technologies, procedures or other methods are currently used by the tobacco industry (including but not limited to, manufacturers, importers, distributors, and retailers) to restrict or minimize a minor's exposure to the forms of advertising, promotion, and marketing of tobacco products described in questions 11 and 12?

In March 2007, NAAG sent requests to approximately 50 tobacco companies, representing all Participating Manufacturers to the Master Settlement Agreement, seeking information about the websites on which they promoted or sold their cigarette brands, and any age verification methods that they employed on those websites. Attached at Appendix 7 is an example of the request letter, together with the responses received from those manufacturers that maintained such websites. These responses describe the methods and technologies used by those companies, including third-party vendors, for their promotional websites. (None of the respondents reported having a website for selling its products.)

Other than the information obtained from these responses, which reflects methods and technologies employed by certain tobacco companies to prevent underage access to their brand promotional websites as of 2007, we are aware of no comprehensive data that reflect the current status of methods or technology employed to prevent underage access to company brand websites, or to prevent underage exposure or access to tobacco company advertisements or promotions that are placed on other online or digital media.

At the same time, little or no information is publicly available regarding the extent to which tobacco companies are using - or the amount of money they are spending on - digital or other online media to advertise or market their products. In 2011, the Federal Trade Commission issued its report on cigarette sales, advertising, and promotion by the largest U.S. cigarette manufacturers for the years 2007 and 2008. Expenditures for company websites, reported in the aggregate, were \$6.5, \$2.4, and \$13.2 million for 2006, 2007, and 2008 respectively. FTC Cigarette Report for 2007 and 2008 at 6-7.⁴ (While the website expenditures represent a small fraction of the overall tobacco company advertising and promotional expenditures of \$12.5, \$10.8, and \$9.9 billion for the same years, we note that online and digital advertising may be far less expensive than traditional print, radio or television advertising.) To avoid potential disclosure of individual company data, however, the FTC did not report how much money the tobacco companies stated they spent on other forms of Internet advertising aside from company websites. *Id.* at 3 n.4 and 6 n.8. In its most recent August 2011 order to the tobacco companies, in addition to reportable expenditures for advertising on company websites and elsewhere on the Internet, the FTC has added a separate category of reportable expenditures for advertising on any social media marketing. *See* FTC Order to File Special Report, Issued Aug. 9, 2011, File No. P114508, Reportable Expenditures 48 (company Internet website), 49 (on Internet other than company website) and 51 (social media marketing).⁵ It is possible, therefore, that the FTC will also withhold data for these advertising expenditures when it releases its Cigarette Report for 2009 and 2010.

For these reasons, we suggest that the FDA work in cooperation with the FTC to (1) review all of the expenditure data already submitted by the tobacco companies to the FTC; and (2) require the companies to identify the precise nature of all Internet and other digital marketing, as well as the methods and technologies employed to prevent underage access, and what they are doing to test and measure the effectiveness of those methods and technologies.

We further encourage the FDA to work with the FTC to explore ways of obtaining information about the youth audience size and composition for all online/digital media where

⁴ Available at: <http://ftc.gov/os/2011/07/110729cigaretterereport.pdf>

⁵ Available at: <http://www.ftc.gov/os/2011/08/2011cigaretterereport.pdf>

tobacco companies, or others who sell tobacco products, place their advertising. Armed with such information, the goal of minimizing youth exposure to digital tobacco advertisements may be achieved by applying the format and content restrictions currently imposed by the FDA's regulation for cigarette and smokeless tobacco labeling and advertising, set forth in 21 CFR § 1140.32, assuming that the constitutionality of that provision is ultimately upheld.

IV. PAYMENT METHODS

QUESTION 6: What payment methods are used for the sale of tobacco products through non-face-to-face exchanges?

State Efforts to Reduce Use of Credit Cards for Illegal Non-Face-to-Face Sales

Since the states started investigating non-face-to-face tobacco product sales, a variety of different types of payment methods have been used to purchase these products, including credit cards, echecks, money orders, checks, wire services such as Moneygram and Western Union, demand drafts, and gift cards. Based on the results of stings conducted by the states over the years, the payment methods online retailers advertised on their websites appeared to vary, at least in part, due to the amount of scrutiny a particular type of payment method received. For example, when states started investigating cigarette websites, credit cards seemed to be the most advertised payment method. As credit card purchases of online tobacco products started receiving more scrutiny, credit card advertising declined and online cigarette retailers moved to the Automated Clearing House (ACH) Network, allowing customers to make electronic purchases (also known as "echecks") facilitated by banks and third-party processors. When the states turned their attention to echecks, the number of websites selling cigarettes through credit card purchases increased.

In 2001, California conducted a major sting in which four children visited 235 websites and purchased cigarettes from 129 of those sites using credit cards. Other states conducting stings also found that many illegal online tobacco sales were being facilitated through credit card purchases. Because of the public health concerns raised by such sales, discussed above, the states then undertook a multi-faceted approach to stopping them. As one component of that approach, the states attempted to obtain agreements from the facilitators of these payment methods - the credit card companies and banks - to stop facilitating them.

In 2005, the states obtained the agreement of four major credit card companies (American Express, Diner's Club, Master Club, and Visa) and PayPal not to facilitate illegal online tobacco sales. See Appendix 1. Specifically, each of the credit card companies agreed that if any states determined that an illegal online tobacco sale occurred and reported that sale to the company, the credit card company would investigate the matter, and, if the illegal sale was confirmed, would order its member bank to terminate the merchant involved. PayPal agreed to implement a more

rigorous policy regarding online tobacco sales, stating that “PayPal may not be used to purchase or sell tobacco, including cigarettes, cigars, and smokeless tobacco due to the many difficulties inherent in assuring that tobacco sales comply with the applicable laws.”

Following the 2005 arrangement, states continued to perform stings to determine whether the credit card companies’ agreements were having the effect of reducing illegal online cigarette sales. The states concluded that the credit card companies, when notified that a particular Internet cigarette retailer was selling cigarettes in violation of state or federal law, were terminating the merchant and, in some cases, penalizing the member bank involved. For example, at the urging of the California Attorney General’s Office, MasterCard imposed a \$25,000 fine on First Regional Bank (“First Regional”), a member bank that had continued to facilitate illegal online tobacco sales even after being notified by California that it was facilitating illegal online tobacco sales. However, the credit card companies would not agree to do their own due diligence to determine if these illegal tobacco sales were being facilitated through the use of their credit cards.

As the states continued to report illegal online cigarettes sales to the credit card companies, and the credit card companies ordered their member banks to stop facilitating these sales, credit card use dwindled, and many online tobacco retailers turned to banks and third-party processors to assist them in facilitating illegal online tobacco sales electronically through the ACH Network, and to a lesser extent through other payment methods such as Moneygrams, gift cards, and demand drafts. For example, California conducted another sting in 2006, one year after the agreement with the credit card companies, and found that cigarette purchases through the ACH Network had overtaken credit cards as the most advertised payment method on the Internet. However, credit card advertisements still came in second, well above other payment methods.

State Efforts to Reduce Use of ACH Network for Illegal Non-Face-to-Face Sales

The states have learned that stopping illegal sales through the ACH Network is even more problematic than stopping such sales facilitated by credit cards. According to George Thomas,⁶ one of the greatest potentials for risk is with the remote payment methods over the Internet involving the use of third-party merchant processors through the ACH Network.⁷ According to Mr. Thomas, although most financial institutions employ “know your customer” procedures for direct customers, including third-party merchant processors, few financial institutions apply these procedures for the customers of the third-party merchant processor. Such

⁶ Mr. Thomas is a former executive vice president of The Clearing House Payments Co., where he managed the payments division. He is now the CEO of Radix consulting corp., Oakdale, New York, and serves as a consultant to NAAG. Mr. Thomas’s articles on this subject are attached to the comments at Appendix 9.

⁷ George F. Thomas, *Not Your Father’s ACH* (July 2007), ICBA Independent Banker, at page 95.

customers can include other third-party merchant processors, independent sales organizations, and merchants.⁸ Mr. Thomas also states that many of the merchants that use third-party processors do so because they could not pass the standard know-your-customer procedure if they approached a financial institution directly.⁹

To illustrate the difficulties these electronic payment methods pose, several states have asked banks caught in stings to stop facilitating illegal online cigarette sales, and to institute due diligence procedures for their customers and their customers' customers. Most banks have refused. One especially egregious example demonstrates the reasons why banks need to have sufficient due diligence procedures in place to ensure that they are not facilitating the sale of contraband cigarettes over the Internet. California learned through a sting and subsequent investigation that First Regional Bank, a California bank, and its third-party merchant processor, Electronic Clearing House ("ECHO") facilitated massive numbers of illegal non-face-to-face cigarette sales of a nationwide cigarette seller. Over 166,000 of these contraband cigarette sales were made to California consumers alone. Neither the bank nor the processor had adequate due diligence procedures in place to ensure that such illegal sales were not facilitated.

What made this an especially egregious case is that First Regional allowed ECHO to use its routing number, so that ECHO would be directly connected to the ACH Network and would not have to first process these transactions through the bank. In such cases, when a third-party merchant processor is allowed to go directly to the ACH operator, the bank often does not have sufficient due diligence procedures in place to ensure that the bank is not facilitating violations of the law. Specifically, the bank has no knowledge of forward or return activity until the financial transaction has been completed. In this case, neither First Regional nor ECHO had such procedures in place. In this type of situation, the bank knows neither its customers nor the customers of its third-party processors. In fact, according to Mr. Thomas, merchants engaged in questionable transactions often seek the assistance of a third-party processor because they know that if they went to the bank directly, they would not be taken on as a customer.

After Master Card terminated the online retailer and fined First Regional \$25,000 for violating Master Card's rules by facilitating illegal online cigarette sales, and after California told First Regional's and ECHO's attorneys that California had filed a Complaint against the online cigarette merchant whose illegal sales they had facilitated, both entities agreed to enter into Assurances of Discontinuance ("AOD's") with California, New York, and Idaho in which they agreed to stop facilitating illegal online tobacco sales. Additionally, they agreed to create and implement due diligence "Know Your Customer and Your Customers' Customers" policies

⁸ *Id.*

⁹ *Id.* at 95-96.

designed to ensure that such illegal transactions will not be facilitated inadvertently. *See* Appendix 8.

Discussions with Federal and Other Regulators

In a further effort to address the issue of electronic payments for online tobacco product purchases, in 2005 NAAG contacted the National Automated Clearing House Association (“NACHA”), which is the association that creates and implements rules for member banks processing transaction through the ACH Network. NAAG asked NACHA for assistance in stopping illegal online tobacco sales through the ACH Network. While NACHA distributed a Bulletin to its members asking them not to facilitate such transactions, NACHA did nothing further to ensure that its members did not facilitate illegal online tobacco sales and there is no evidence that NACHA’s members complied with NACHA’s request. *See* Appendix 10.

In 2010, state and NAAG representatives met with federal regulators, including the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the FTC, the Federal Reserve and others to discuss what the regulators could do to stop the illegal facilitation of online cigarette sales by banks and third party processors. The states also expressed the need for the regulators to require banks and their third-party merchant processors to require the implementation of rigorous due diligence policies and procedures. While these regulators indicated that they would be willing to assist on a case-by-case basis, they did not provide any further assistance. One additional complicating factor is that none of the federal regulators is responsible for specifically regulating third-party processors.

More recently, demand drafts have been used as another type of payment method in connection with non-face-to-face sales. California learned through a sting that at least one online cigarette seller required demand drafts in the purchase of online cigarettes. When the state’s investigator attempted to buy the online cigarettes, the seller asked for a check number and created a demand draft and in place of the signature he printed a statement on the signature line of the check stating that “This draft authorized by your depositor.” The problem was brought to the attention of the merchant’s bank, which had no idea that a number of deposits had been made using demand drafts by this merchant. This payment method allows the merchant to avoid scrutiny entirely because the seller deposited many similar deposits in his individual account rather than creating a merchant account and risking greater scrutiny of the transactions.

Evaluation of the States’ Efforts to Stop Payment Facilitation for Illegal Non-Face-to-Face Tobacco Sales

The approach of presenting credit card companies, financial institutions, and bank regulators with information about violators on a case-by-case basis has been time-consuming and inefficient, as it relies on states discovering violations of their laws through stings rather than the

regulators taking the initiative to require banks, credit card companies and third-party processors to apply due diligence procedures so as to stop the illegal sales before they enter the payment system. The states' success, or lack thereof, in stopping the facilitation of these illegal sales has thus been dependent on the states' ability to obtain the cooperation of banks, credit card companies, third-party payment processors and others; and the willingness of federal regulators to impose sanctions on violators. A further problem is that no federal agency has specific responsibility for regulating third-party processors. In sum, while the states have had some success in this area, additional regulation is clearly needed.

Accordingly, we believe prevention of illegal sales of tobacco products would be enhanced if federal regulators: (1) required banks, credit card companies, and third-party processors and others facilitating illegal Internet sales to implement due diligence procedures; and (2) imposed sanctions for non-compliance with such procedures. This would appear to be a subject on which the FDA could effectively partner with the federal agencies that regulate financial institutions.

Given the difficulties in addressing the problem of the facilitation of payments for illegal sales of tobacco products, however, a ban on such sales may be the only effective means of preventing such sales.

V. IMPLEMENTATION OF PACT ACT

The PACT Act has several major components of interest to states:

- All persons who sell, ship or transfer cigarettes (defined in PACT to include RYO tobacco) and smokeless tobacco in interstate commerce, or who advertise or offer such sale, transfer or shipment, including Delivery Sellers, must register with the Attorney General of the United States and register and report shipments to the tobacco tax administrator of the states into which shipments are made. This requirement potentially provides the states with valuable information for identifying, stopping, and preventing illegal cigarette trafficking, including sales that evade state excise taxes and escrow payments.
- Delivery sellers must comply with state laws generally applicable to sales of cigarettes and smokeless tobacco as if the delivery sale occurred entirely within the state in which the delivery was made, including state laws relating to excise taxes, licensing and tax-stamping requirements, and restrictions on sales to minors. In addition, because state laws prohibiting all delivery sales are specifically not preempted by PACT, delivery sales to such states are prohibited. This requirement potentially facilitates the effective enforcement of state excise tax and age verification laws.

- Delivery sellers must clearly and conspicuously label each package of cigarettes or smokeless tobacco as follows: “CIGARETTES/SMOKELESS TOBACCO: FEDERAL LAW REQUIRES THE PAYMENT OF ALL APPLICABLE EXCISE TAXES, AND COMPLIANCE WITH APPLICABLE LICENSING AND TAX-STAMPING OBLIGATIONS.”
- Delivery sellers must verify the age and identity of purchasers prior to sale and use a method of shipment that verifies the age and identity upon delivery to ensure that deliveries are not made to persons under the legal age as determined by the law in the place of delivery.
- The Attorney General of the United States maintains a list of delivery sellers that do not comply with the Act’s requirements, and no one may deliver cigarettes or smokeless tobacco sold by a person or entity on that list. This provision aids in the enforcement of the Act’s reporting, registration, and compliance requirements.
- Cigarettes and smokeless tobacco are non-mailable by the United States Postal Service. This shuts off what has been the principal means by which cigarette and smokeless tobacco direct sellers have shipped their products notwithstanding the agreement of the major common carriers not to transport them.

Two federal courts have enjoined on due process grounds the second component of the Act listed above – *i.e.*, the requirement that delivery sellers comply with applicable state laws. *Red Earth v. U.S.*, 657 F. 3d 138 (2d Cir. 2011); *Gordon v. Holder*, 2011 U.S. Dist. LEXIS 139201, (D.D.C. Dec. 5, 2011).¹⁰ In a third case, *Musser’s Inc. v. U.S.*, (E.D. Pa., No. 10-4355, Sept. 26, 2011), the United States District Court for the Eastern District of Pennsylvania denied a preliminary injunction against enforcement of the PACT Act. All of these decisions upheld the validity of the non-mailability provision. Because delivery sellers no longer must comply with state laws, the list that the Attorney General maintains of non-compliant delivery sellers is also of reduced significance. If the requirement that delivery sellers comply with state tax and other laws is eventually struck on due process grounds, a key aspect of the PACT Act will no longer be operative.

Apart from uncertainties introduced by these judicial challenges to the PACT Act, there have been various questions regarding the effectiveness of its implementation. First, numerous companies have refused to comply with the Act’s reporting and registration requirements. Some

¹⁰ These decisions do not enjoin the provision of the PACT Act that exempts state delivery bans from preemption.

companies have claimed that the reporting requirements apply only to delivery sellers and not to other persons selling, transferring or shipping cigarettes or smokeless tobacco in interstate commerce. Some Native American-owned companies are contending that they are beyond the reach of state enforcement and therefore need not comply with the Act's provisions relating to registering with or reporting to states. ATF has issued interpretations of the Act that rebut these claims and contentions, but ATF determined that it will not be issuing regulations under the Act, and the companies that are resisting the Act's requirements are questioning ATF's interpretations as well as its authority to issue them.

Second, the non-mailability provision has not prevented what we believe to be large volumes of cigarettes and smokeless tobacco from continuing to be shipped to consumers in a manner that violates the provisions of PACT that are not enjoined, as well as state delivery sales bans. This is occurring because (a) some sellers have been able to put their products in the mail; and (b) some sellers have devised their own methods of transport, bypassing common carriers. With regard to the use of the U.S Postal Service, this is a problem for both domestic and international shipments. Some states have reported that they have purchased, through stings, cigarettes or smokeless tobacco from domestic sources that were delivered by the USPS without proper labeling or age verification; it appears, therefore, that the non-mailability provision is not being enforced in a complete or uniform way. Moreover, other states have reported purchasing cigarettes or smokeless tobacco from foreign sources, where the cigarettes were shipped through international mail. The latter tobacco products are examined first by U.S. Customs and Border Protection ("CBP"), which has the authority to open packages for inspection without a warrant. It appears that CBP is not intercepting all international shipments of cigarettes or smokeless tobacco, leaving it to ATF and the USPS, which lack CBP's enforcement tools, to deal with the problem.

We believe it is likely that any shortfalls in enforcement of the PACT Act translate directly to increased access by youth to cigarettes and smokeless tobacco, as direct sales are one of the principal means by which youth are able to acquire these tobacco products.

In response to question 10 of the ANPR, we believe it would be appropriate for the protection of the public health for the FDA, in exercising its authority under section 906(d) of the Tobacco Control Act, to work with the relevant federal agencies and USPS toward more effective enforcement of the PACT Act, particularly in the areas described above. We believe states would also be prepared to work cooperatively toward that objective.

CONCLUSION

Neither the PACT Act nor the state laws now in effect have proven adequate to protect the public health against the two principal adverse effects of non-face-to-face sales of tobacco

products – *i.e.*, making such products less expensive through evasion of state taxes and making them more readily available to youth.

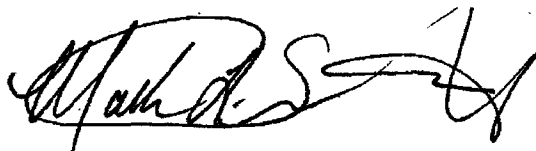
Age verification continues to be a challenge in connection with both purchase and delivery of tobacco products. Moreover, efforts by states to work with carriers, financial institutions, and tobacco manufacturers to prevent sales that violate state laws have been hampered by the need to work on a case-by-case basis. State laws provide only a patchwork approach that direct sellers have, in some instances, been able to exploit, and states have been frustrated by jurisdictional limitations and the ability of direct sellers to move their operations to new locations and/or websites when challenged. While the PACT Act has represented an advance over the situation prior to its enactment, key provisions of the Act remain enjoined and enforcement has encountered obstacles, as discussed above.

In short, unlawful non-face-to-face sales are a nationwide problem requiring a nationwide solution. It appears that the only way to remedy the adverse public health consequences of such sales is to follow the approach taken by eight states¹¹ and ban them. Absent such a federal ban, we recommend that the FDA work with other federal agencies toward more effective enforcement of the PACT Act and implementation of due diligence procedures by federally regulated financial institutions to prevent facilitation of payments for illegal non-face-to-face sales.

Sincerely yours,



Dustin McDaniel
Attorney General of Arkansas
Co-Chair, NAAG Tobacco Committee



Mark Shurtleff
Attorney General of Utah
Co-Chair, NAAG Tobacco Committee

¹¹ Arkansas, Connecticut, Maryland, New York, Ohio, Utah, Vermont, and Washington.

APPENDICES

1. Agreements with credit card companies.
2. Agreements with carriers.
3. Protocols with Philip Morris USA Inc. and Lorillard Tobacco Co.
4. Attorney General letters supporting enactment of PACT Act.
5. List of state statutes relating to non-face-to-face sales.
6. Documents from legislative history of state statutes banning non-face-to-face sales.
7. NAAG request to Participating Manufacturers for information regarding age verification techniques on their websites, and Participating Manufacturers' responses.
8. Assurances of Discontinuance with ECHO and First Regional Bank.
9. Articles by George Thomas, consultant to NAAG.
10. NAAG letter to NACHA and NACHA bulletin to member financial institutions.