**FEDERAL RESERVE SYSTEM**

**12 CFR Part 235**

**Regulation II; Docket No. R-1404**

**RIN No. 7100 AD 63**

# Debit Card Interchange Fees and Routing

**AGENCY:** Board of Governors of the Federal Reserve System

**ACTION:** Final rule

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**SUMMARY:** The Board is publishing a final rule, Regulation II, Debit Card Interchange Fees and Routing. This rule implements the provisions of Section 920 of the Electronic Fund Transfer Act, including standards for reasonable and proportional interchange transaction fees for electronic debit transactions, exemptions from the interchange transaction fee limitations, prohibitions on evasion and circumvention, prohibitions on payment card network exclusivity arrangements and routing restrictions for debit card transactions, and reporting requirements for debit card issuers and payment card networks. An interim final rule, with a request for comment, on standards for receiving a fraud-prevention adjustment to interchange transaction fees is published separately in the *Federal Register*.

**DATES:** The final rule is effective October 1, 2011, except § 235.7(a). Section 235.7(a) is effective on April 1, 2012, except for payment card networks, and issuers with respect to debit cards that use transaction qualification or substantiation systems and general-use prepaid cards. For payment card networks, §§ 235.7(a)(1) and (a)(3) are effective on October 1, 2011. For issuers, the effective date is April 1, 2013 with respect to debit cards that use transaction qualification or substantiation systems and general-use prepaid cards. Reloadable general-use prepaid cards sold and reloaded prior to April 1, 2013 must comply with § 235.7(a) by May 1,

2013. Reloadable general-use prepaid cards sold prior to April 1, 2013 and reloaded after April 1, 2013 must comply within 30 days of the reloading.

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**SUPPLEMENTARY INFORMATION:**

**I. Section 1075 of the Dodd-Frank Act**

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") was enacted on July 21, 2010.[1] Section 1075 of the Dodd-Frank Act amends the Electronic Fund Transfer Act ("EFTA") (15 U.S.C. § 1693 et seq.) by adding a new section 920 regarding interchange transaction fees and rules for payment card transactions.[2]

EFTA Section 920(a)(2) provides that, effective July 21, 2011, the amount of any interchange transaction fee that an issuer receives or charges with respect to an electronic debit transaction must be reasonable and proportional to the cost incurred by the issuer with respect to the transaction.[3] Section 920(a)(3) requires the Board to establish standards for assessing whether an interchange transaction fee is reasonable and proportional to the cost incurred by the issuer with respect to the transaction.

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[1] Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[2] EFTA Section 920 is codified as 15 U.S.C. 1693o-2. As discussed in more detail below, EFTA Section 920(c)(8) defines "an interchange transaction fee" (or "interchange fee") as any fee established, charged, or received by a payment card network for the purpose of compensating an issuer for its involvement in an electronic debit transaction.

[3] Electronic debit transaction (or "debit card transaction") is defined in EFTA Section 920(c)(5) as a transaction in which a person uses a debit card.

Under EFTA Section 920(a)(5), the Board may allow for an adjustment to an interchange transaction fee that is reasonably necessary to make allowance for costs incurred by the issuer in preventing fraud in relation to electronic debit transactions, provided the issuer complies with standards established by the Board relating to fraud prevention. Section 920(a)(8) also authorizes the Board to prescribe regulations in order to prevent circumvention or evasion of the restrictions on interchange transaction fees, and specifically authorizes the Board to prescribe regulations regarding any network fee to ensure that such a fee is not used to directly or indirectly compensate an issuer with respect to an electronic debit transaction and is not used to circumvent or evade the restrictions on interchange transaction fees.

EFTA Sections 920(a)(6) and (a)(7) exempt certain issuers and cards from the restrictions on interchange transaction fees described above. The restrictions on interchange transaction fees do not apply to issuers that, together with affiliates, have assets of less than $10 billion. The restrictions also do not apply to electronic debit transactions made using two types of debit cards—debit cards provided pursuant to certain government-administered payment programs and certain reloadable, general-use prepaid cards not marketed or labeled as a gift card or gift certificate. Section 920(a) provides, however, that beginning July 21, 2012, these two types of debit cards will not be exempt if the cardholder may be charged either an overdraft fee or a fee for the first withdrawal each month from automated teller machines ("ATMs") in the issuer's designated ATM network.

In addition to rules regarding restrictions on interchange transaction fees, EFTA Section 920(b) requires the Board to prescribe rules related to the routing of debit card transactions. First, Section 920(b)(1) requires the Board to prescribe rules that prohibit issuers and payment card networks ("networks") from restricting the number of networks on which an

electronic debit transaction may be processed to one such network or two or more affiliated networks. Second, that section requires the Board to prescribe rules prohibiting issuers and networks from inhibiting the ability of any person that accepts debit cards from directing the routing of electronic debit transactions over any network that may process such transactions.

Section 920(a) requires the Board to establish interchange fee standards no later than April 21, 2011, and that section becomes effective on July 21, 2011. Section 920(b) requires the Board to issue rules that prohibit network exclusivity arrangements and debit card transaction routing restrictions no later than July 21, 2011, but does not establish an effective date for these provisions.

On December 28, 2010, the Board requested public comment on a proposed rule for implementing these provisions of the Dodd-Frank Act. As explained below, the Board received comments from more than 11,500 commenters regarding this proposal, including comments from issuers, payment card networks, merchants, consumers, consumer advocates, trade associations, and members of Congress. Prior to publishing its proposed rule, the Board also conducted a survey of issuers covered by EFTA Section 920 and of payment card networks to gather information regarding electronic debit transactions and related costs. Based on its review of the comments, the statutory provisions, the data available to the Board regarding costs, its understanding of the debit payment system, and other relevant information, and for the reasons explained below, the Board has adopted this final rule. A companion interim final rule providing for a fraud-prevention adjustment to the interchange fee standards was also adopted, with a request for comment on the interim final rule.[4]

## II. The debit card industry

### A. Overview of the debit card industry

[4] *See* companion interim final rule published separately in the *Federal Register*.

When introduced in the late 1960s and early 1970s, debit cards provided a new way for consumers to access funds in their deposit accounts, supplementing more traditional means such as checks and in-person withdrawals at bank branches.[5] Although initially debit cards were used to withdraw cash or perform other banking activities at ATMs, the system evolved to support payments made by consumers for the purchase of goods or services at merchants. Cardholders are also able to use their debit cards to get cash back at certain point-of-sale locations as part of the purchase transaction. Debit cards are generally issued by depository institutions to their deposit account holders.

Debit cards now play a prominent role in the U.S. payments system. Debit card payments have grown more than any other form of electronic payment over the past decade, increasing to 37.9 billion transactions in 2009.[6] Debit cards are used in 35 percent of noncash payment transactions, and have eclipsed checks as the most frequently used noncash payment method. Almost half of total third-party debits to deposit accounts are made using debit cards, compared to approximately 30 percent made by checks.[7,8] Debit cards are accepted at about 8 million merchant locations in the United States.

A more recent innovation in card-based payments is the introduction of prepaid cards. Prepaid cards may or may not be reloadable and may be accepted broadly or restricted to purchases at particular merchants or for specific types of products. Prepaid card transaction

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[5] Check use has been declining since the mid-1990s as checks (and most likely some cash payments) are being replaced by electronic payments (e.g., debit card payments, credit card payments, and automated clearing house (ACH) payments).

[6] The numbers in this discussion are derived from the 2010 Federal Reserve Payments Study, available at http://www.frbservices.org/files/communications/pdf/press/2010_payments_study.pdf. Accordingly, these figures may vary from those discussed in connection with the Board's survey of covered issuers and payment card networks.

[7] Third-party debits are those debits initiated to pay parties other than the cardholder. These third-party debit numbers are derived from the 2010 Federal Reserve Payments Study. The Study reported that a total of 108.9 billion noncash payments were made in 2009, 35 percent of which were debit card payments. For purposes of determining the proportion of noncash payments that were third-party debits to accounts, ATM cash withdrawals and prepaid card transactions are excluded from the calculation.

[8] Board staff projects that debit card transactions will total about 50 billion in 2011.

volume is still low in comparison to other forms of electronic payments, such as debit cards, but is increasing rapidly. In particular, prepaid cards were used for 6 billion transactions in 2009, valued at $140 billion, with average annual growth rates of prepaid transaction volume and value of more than 20 percent between 2006 and 2009.[9]

In general, there are two types of debit card authentication methods on which current systems are based: PIN (personal identification number) and signature.[10] The infrastructure for PIN debit networks differs from that for signature debit networks. PIN debit networks, which evolved from the ATM networks, are single-message systems in which authorization and clearing information is carried in a single message. Signature debit networks, which leverage the credit card network infrastructure, are dual-message systems, in which authorization information is carried in one message and clearing information is carried in a separate message.

The authentication methods available for a given transaction generally depend on features of the consumer's card, the transaction, and the merchant's acceptance policy. According to the Board's survey of covered card issuers, more than 70 percent of debit cards outstanding (including prepaid cards) support both PIN- and signature-based transactions (88 percent, excluding prepaid cards).[11] In the current environment, however, certain transactions, such as transactions for hotel stays or car rentals, where the exact amount of the transaction is not known at the time of authorization, cannot readily be accommodated on PIN-based, single-message

[9] These prepaid numbers are based on the 2010 Federal Reserve Payments Study, which gathered information on both general-use and private-label prepaid cards. According to that study, of the reported 6.0 billion prepaid card transactions in 2009, 1.3 billion were general-use prepaid card transactions, valued at $40 billion, and 4.7 billion were private-label prepaid card and electronic benefit transfer ("EBT") card transactions, valued at $90 billion. Combined, in 2009, debit and prepaid cards accounted for 43.9 billion transactions or 40 percent of noncash payment transactions. Debit and prepaid card transaction volume of 37.6 billion reported by networks in the Board's interchange survey differed from the transaction volume of 39.2 billion (excluding private-label prepaid and EBT card transactions) reported in the Federal Reserve Payments Study because some networks reported different volumes in the two surveys.

[10] Increasingly, however, cardholders authorize "signature" debit transactions without a signature and, sometimes, may authorize a "PIN" debit transaction without a PIN. PIN-based and signature-based debit also may be referred to as "PIN debit" and "signature debit."

[11] "Covered issuers" are those issuers that, together with affiliates, have assets of $10 billion or more.

systems. In addition, PIN debit transactions generally are not currently accepted for Internet, telephone, and mail transactions. Overall, information collected by the Board indicates that roughly one-quarter of the merchant locations in the United States that accept debit cards have the capability to accept PIN-based debit transactions. Further, as discussed below in connection with § 235.2(m), new types of debit card transactions are emerging that are not "PIN-based" or "signature-based" as those terms traditionally have been used and use new cardholder authentication methods.

Debit card transactions typically are processed over one of two types of systems, often referred to as three-party and four-party systems.[12] The so-called four-party system is the model used for most debit card transactions; the four parties are the cardholder, the entity that issued the payment card to the cardholder (the issuer), the merchant, and the merchant's bank (the acquirer or merchant acquirer).[13] The network receives transaction information and data from the acquiring side of the market, routes the information to the issuer of the card (authorization and clearing), and determines each side's daily net settlement positions for interbank monetary transfers.[14]

In a three-party system, one entity acts as issuer and system operator, and often as acquirer as well. Thus, the three parties involved in a transaction are the cardholder, the merchant, and the system operator. The three-party model is used for some prepaid card transactions, but currently is not used for other debit card transactions in which the cardholder is debiting his or her bank account.

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[12] Industry participants sometimes refer to four-party systems as "open loop" systems and three-party systems as "closed loop" systems.

[13] Throughout this rule, the term "bank" may be used to refer to any depository institution.

[14] The term "four-party system" is something of a misnomer because the network is, in fact, a fifth party involved in a transaction.

In a typical four-party system transaction, the cardholder initiates a purchase by providing his or her card or card information to a merchant. In the case of PIN debit, the cardholder also enters a PIN. An electronic authorization request for a specific dollar amount, along with the cardholder's account information, is sent from the merchant to the acquirer to the network, which sends the request to the appropriate card-issuing institution.[15] The issuer verifies, among other things, that the cardholder's account has sufficient funds to cover the transaction amount and that the card was not reported as lost or stolen. A message approving or declining the transaction is returned to the merchant via the reverse path, usually within seconds of the authorization request.

The clearing of a debit card transaction is effected through the authorization message (for PIN debit systems) or a subsequent message (for signature debit systems). The issuer posts the debits to the cardholder's account based on these clearing messages. Based on all clearing messages received in one day, the network calculates and communicates to each issuer and acquirer its net debit or credit position for settlement. The interbank settlement generally is effected through a settlement account at a commercial bank, or through ACH transfers. The acquirer credits the merchant's account for the value of its transactions, less the merchant discount, as discussed below. The timing of this crediting is determined by the merchant-acquirer agreement and/or ACH operator rules. In some circumstances, an acquirer that is also the issuer with respect to a particular transaction may authorize and settle that transaction internally.

Various fees are associated with debit card transactions. The interchange fee is set by the relevant network and paid by the acquirer to the issuer; the network accounts for the interchange fee in determining each issuer's and acquirer's net settlement position. Switch fees are charged

[15] Specialized payment processors may carry out some functions between the merchant and the network or between the network and the issuer.

by the network to acquirers and issuers to compensate the network for its role in processing the transaction.[16] The acquirer charges the merchant a merchant discount—the difference between the face value of a transaction and the amount the acquirer transfers to the merchant–that includes the interchange fee, network switch fees charged to the acquirer, other acquirer costs, and an acquirer markup. The interchange fee typically comprises a large fraction of the merchant discount for a card transaction.[17]

When first introduced, some PIN debit networks structured interchange fees in a manner similar to ATM interchange fees.[18] For ATM transactions, the cardholder's bank generally pays the ATM operator an interchange fee to compensate the ATM operator for the costs of deploying and maintaining the ATM and providing the service. Similarly, some PIN debit networks initially structured interchange fees to flow from the cardholder's bank to the merchant's bank to compensate merchants for the costs of installing PIN terminals and making necessary system changes to accept PIN debit at the point of sale. In the mid-1990s, these PIN debit networks began to shift the direction in which PIN debit interchange fees flowed. By the end of the decade, interchange fees for all PIN debit transactions in the United States were paid by acquirers to card issuers.[19]

During the 1990s, most PIN debit networks employed fixed per-transaction interchange fees. Beginning around 2000, many PIN debit networks incorporated an *ad valorem* (i.e.,

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[16] A variety of other network fees, such as membership fees and licensing fees, may be collected by the network from the issuer or acquirer.

[17] Merchant discounts generally follow two forms: interchange-plus pricing and blended. If an acquirer is charging an interchange-plus merchant discount, the acquirer passes through the exact amount of the interchange fee for each transaction. If an acquirer is charging a blended merchant discount, the acquirer charges the same discount regardless of the interchange fee that applies to each transaction.

[18] In the late 1970s, bank consortiums formed numerous regional electronic funds transfer ("EFT") networks to enable their customers to withdraw funds from ATMs owned by a variety of different banks. The EFT networks were first used to handle PIN debit purchases at retailers in the early 1980s. It was not until the mid-1990s, however, that PIN debit became a popular method of payment for consumers to purchase goods and services at retail stores.

[19] *Debit Card Directory* (1995–1999). *See also*, Fumiko Hayashi, Richard Sullivan, & Stuart E. Weiner, "A Guide to the ATM and Debit Card Industry" (Federal Reserve Bank of Kansas City 2003).

percentage of the value of a transaction) component to their interchange fees, with a cap on the total amount of the fee for each transaction. In addition, PIN debit networks expanded the number of interchange fee categories in their fee schedules. For example, many networks created categories based on merchant type (e.g., supermarkets) and began to segregate merchants into different categories based on transaction volume (e.g., transaction tiers). Over the course of the 2000s, most PIN debit networks raised the levels of the fixed and *ad valorem* components of fees, in addition to raising the caps on overall fees. By 2010, some networks had removed per-transaction caps on many interchange fees.

In general, interchange fees for signature debit networks, like those of credit card networks, combine an *ad valorem* component with a fixed fee component. Unlike some PIN debit networks, interchange fees for signature debit networks generally do not include a per-transaction cap. Beginning in the early 1990s, signature debit networks also began creating separate categories for merchants in certain market segments (e.g., supermarkets and card-not-present transactions) to gain increased acceptance in those markets.[20] Until 2003, interchange fee levels for signature debit transactions were generally similar to those for credit card transactions and significantly higher than those for PIN debit card transactions. However, PIN debit fees began to increase in the early 2000s, as noted above, while signature debit fees declined in late 2003 and early 2004.[21] More recently, both PIN and signature debit fees have increased, although PIN debit fees have increased at a faster pace.

In addition to setting the structure and level of interchange fees and other fees to support network operations, each card network specifies operating rules that govern the relationships

[20] Card-not-present transactions occur when the card is not physically presented to the merchant at the time of authorization. Examples include Internet, phone, and mail-order purchases.
[21] This decline followed the settlement of litigation surrounding signature debit cards. *See In re: Visa Check/MasterMoney Antitrust Litigation,* 192 F.R.D. 68 (E.D.N.Y. 2000).

between network participants. Although network rules generally apply to issuers and acquirers, merchants and processors also may be required to comply with a network's rules or risk losing access to that network. Network operating rules cover a broad range of activities, including merchant card acceptance practices, technological specifications for cards and terminals, risk management, and determination of transaction routing when multiple networks are available for a given transaction.

**B. Summary information about interchange fees and transaction costs**

In September 2010, the Board surveyed issuers that would be subject to the interchange fee standards and payment card networks to gather information to assist the Board in developing its proposed rule.[22] Preliminary summary information was provided in the Board's proposal.[23] An updated and more detailed summary of this information is provided in "2009 Interchange Revenue, Covered Issuer Costs, and Covered Issuer and Merchant Fraud Losses Related to Debit Card Transactions."[24] What follows is a brief high-level summary of the survey data responses on interchange fees, issuer costs, and merchant and issuer fraud losses. The data results represent only covered issuers and networks that responded to the survey.[25]

*Card use*. Payment card networks reported a total of approximately 37.6 billion debit (including prepaid) card purchase transactions in 2009, with an aggregate value of more than $1.4 trillion. Signature-based transactions accounted for 22.5 billion or 60 percent of all purchase transactions, and $837 billion or 59 percent of transaction value. PIN-based debit

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[22] The Board also surveyed the nine largest merchant acquirers, all of which responded to the survey and provided information on the number and volume of debit card transactions that they processed, the number of merchants that accepted various types of debit cards, fraud losses, fraud prevention activities and costs, and exclusivity arrangements and routing procedures.

[23] 75 FR 81724-26, 81740-42 (Dec. 28, 2010).

[24] http://www.federalreserve.gov/paymentsystems/files/debitfees_costs.pdf.

[25] Most respondents did not provide information for every data element requested in the surveys. As discussed further below under § 235.3, when determining the interchange fee standard, the Board considered only data from issuers that provided information for each included cost.

transactions totaled 13.9 billion or 37 percent of purchase transactions, and $555 billion or 39 percent of transaction value. General-use prepaid card transactions represented 1.2 billion or 3 percent of purchase transactions and $38 billion or 3 percent of purchase transaction value. The average value of all purchase transactions was $38.03, with the average values of signature debit, PIN debit, and prepaid card transactions being $37.15, $40.03, and $31.47, respectively.

*Interchange fees*. Networks reported that debit card interchange fees totaled $16.2 billion in 2009. Of this interchange-fee revenue, $12.5 billion was for signature debit transactions, $3.2 billion was for PIN debit transactions, and $0.5 billion was for prepaid card transactions. The average interchange fee for all debit card transactions was 44 cents per transaction, or 1.15 percent of the average transaction amount. The average interchange fee for signature debit transactions was 56 cents, or 1.53 percent of the average transaction amount. The average interchange fee for PIN debit transactions was significantly lower, at 23 cents per transaction, or 0.58 percent of the average transaction amount. Prepaid card interchange fees averaged 40 cents per transaction, or 1.28 percent of the average transaction amount.[26]

*Issuer processing costs*. The Board's survey requested covered issuers to report their total transaction processing costs, including fixed and variable costs and network processing fees associated with authorization, interbank clearing and settlement, and cardholder account posting for routine purchase transactions and non-routine transactions, such as chargebacks and errors. The median per-transaction total processing cost across issuers for all types of debit card

[26] Some of these numbers differ from those published in the *Federal Register* notice of proposed Regulation II (75 FR 81725 (Dec. 28, 2010)) because several networks subsequently submitted corrections to previously provided data. In one instance, a network corrected the number of prepaid transactions and PIN debit transactions.

transactions was 11 cents per transaction. The 80th percentile of per-transaction total processing cost across issuers for all types of debit card transactions was 19 cents.[27]

*Issuer fraud-prevention and data-security costs*. The median issuer cost for all debit card-related fraud-prevention activities (excluding data-security costs, which were reported separately) was approximately 1.7 cents and the 80th percentile was 3.1 cents. The most commonly reported fraud-prevention activity was transaction monitoring. The median issuer cost for transaction monitoring was 0.7 cents, and the 80th percentile was 1.2 cents. The remaining costs related to a variety of fraud-prevention activities, including research and development, card activation systems, PIN customization, merchant blocking, and card authentication systems; the per-transaction cost of each individual activity was small, typically less than one-tenth of a cent. The median total data-security cost reported by issuers was approximately 0.1 cents and the 80th percentile was 0.4 cents.

*Network Fees and Incentives*. The payment card networks reported various network fees that they charge to issuers and acquirers. Total network fees exceeded $4.1 billion. Networks charged issuers more than $2.3 billion in fees and charged acquirers over $1.8 billion in fees. Almost 76 percent of the total fees paid, or $3.1 billion, were charged by signature debit networks. More than $3.4 billion, or 82 percent of total fees paid, were assessed on a per-transaction basis. Networks paid issuers almost $700 million and acquirers more than $300 million in discounts and incentives. Of the total incentives or discounts paid by networks, 81 percent were paid by signature networks.

*Fraud losses*. The Board estimates that industry-wide fraud losses to all parties of a debit card transaction were approximately $1.34 billion in 2009. About $1.11 billion of these losses

[27] For signature debit transactions, the median issuer per-transaction cost was 13 cents and the 80th percentile was 21 cents. For PIN debit transactions, the median and 80th percentile issuer per-transaction costs were 8 cents and 14 cents, respectively. For prepaid card transactions, they were 61 cents and $1.52, respectively.

arose from signature debit card transactions, about $181 million arose from PIN debit card transactions, and almost $18 million arose from prepaid card transactions.[28] Across all transaction types, the median number of purchase transactions that were fraudulent was about 3 of every 10,000 transactions. The medians for signature, PIN, and prepaid debit card were 4, less than 1, and 1 of every 10,000 transactions, respectively. The median loss per purchase transaction incurred by both issuers and merchants was about 3 cents.[29] The median fraud loss as a percent of purchase transaction value was about 9 basis points. For issuers alone, the median loss per purchase transaction was about 2 cents, and the median fraud loss as a percent of purchase transaction value was approximately 5 basis points.[30]

Across all types of transactions, 62 percent of reported fraud losses were borne by issuers and 38 percent were borne by merchants. The distribution of fraud losses between issuers and merchants differs significantly based on the cardholder authentication method used in a debit card transaction. Issuers reported that nearly all the fraud losses associated with PIN debit transactions (96 percent) were borne by issuers. By contrast, reported fraud losses for signature debit and prepaid card transactions were distributed more evenly between issuers and merchants. Specifically, issuers and merchants bore 59 percent and 41 percent of signature debit fraud

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[28] Revisions in the data plus the inclusion of prepaid card fraud have led to changes to some of the industry-wide fraud loss estimates that were included in the proposal. 75 FR 81740-41 (Dec. 28, 2010). The higher losses for signature debit card transactions result from both a higher rate of fraud and higher transaction volume for signature debit card transactions. The sum of debit card program fraud losses will not equal the industry-wide fraud losses due to different sample sizes and rounding.

[29] Issuers charge back transactions to acquirers that, in turn, typically pass on the chargeback value to the merchant.

[30] For signature debit, the median loss per purchase transaction to both issuers and merchants was 5 cents, and the median fraud loss as a percentage of purchase transaction value was about 12 basis points. This corresponds to a median fraud loss per purchase transaction to issuers of 3 cents and a median fraud loss as a percentage of purchase transaction value of 7 basis points. For PIN debit, the median loss per purchase transaction to both issuers and merchants was 1 cent and the median fraud loss as a percentage of purchase transaction value was about 3 basis points. This corresponds to a median fraud loss per purchase transaction to issuers of 1 cent and a median fraud loss as a percentage of purchase transaction value of 2 basis points. For prepaid, the median loss per purchase transaction to both issuers and merchants was 1 cent, and the median fraud loss as a percentage of purchase transaction value was 3 basis points. This corresponds to a median fraud loss per purchase transaction to issuers of 1 cent and a median fraud loss as a percentage of purchase transaction value of 2 basis points.

losses, respectively. Issuers and merchants bore 67 percent and 33 percent of prepaid fraud losses, respectively.

*Other debit card program costs*. The issuer survey collected information on other costs related to debit card programs, including costs associated with card production and delivery, cardholder inquiries, rewards and other incentives, research and development, nonsufficient funds handling, and compliance. For each issuer that reported these costs, the costs were averaged over the total number of debit card transactions processed by the issuer. The median per transaction cost of production and delivery of cards was 2 cents, cardholder inquiries 3 cents, rewards and other incentives 2 cents, research and development 1 cent, nonsufficient funds handling 1 cent, and compliance less than 0.5 cents.

### C. Comparison to checking transactions

#### 1. Summary of proposal and comments

EFTA Section 920(a)(4)(A) requires the Board to consider, in prescribing standards governing debit interchange fees, the functional similarity between electronic debit transactions and checking transactions that are required to clear at par within the Federal Reserve System. As part of its proposal, the Board described both the similarities and differences between electronic debit transactions and checking transactions. The similarities noted by the Board included the fact that both types of transactions result in a debit to an asset account; both involve electronic processing and, increasingly, deposit; both involve processing fees paid by merchants to banks and other intermediaries; and both have similar settlement timeframes. The differences noted by the Board included the closed nature of debit card systems compared to the open check clearing and collection system; the payment authorization that is an integral part of electronic debit card transactions (but not check transactions), which guarantees that the transaction will not be

returned for insufficient funds or certain other reasons (e.g., a closed account); processing and collection costs incurred by the issuer (analogous to the payor's bank) for electronic debit transactions but not for check; par clearance in the check system; restricted routing choice in the debit card environment; and the ability to reverse electronic debit transactions within the normal processing system.[31]

The Board considered the functional similarity between electronic debit transactions and checks in determining which allowable costs to include under its proposal. In part based on this comparison, the Board proposed to include only those costs that are incurred with respect to a particular transaction that are related to authorization, clearance, and settlement of the transaction. The Board noted that a payor's bank in a check transaction (analogous to the issuer in a debit card transaction) would not recoup such costs from the payee's bank (analogous to the merchant acquirer in a debit card transaction), but that these were costs that EFTA Section 920(a) specifically directed the Board to consider in setting standards governing interchange transaction fees.

The Board received several comments from issuers, networks, and merchants on the functional similarities and differences between electronic debit transactions and check transactions, as well as comments on how the Board should take those similarities and differences into consideration. Merchants and their trade groups suggested that the starting point for the comparison to checks should be the cost savings that issuers receive from processing a debit card transaction rather than a check.

By contrast, numerous issuers and networks asserted that the Board's interchange fee standards should reflect not only the similarities between checks and debit cards, but also the

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[31] *See* 75 FR 81734 (Dec. 28, 2010) for a more detailed comparison between checks and electronic debit transactions in the Board's proposal.

differences between checks and debit cards. As a result, these commenters believed that the comparison to checks would expand the scope of allowable costs. Several issuers and networks argued that, by tying the amount of an interchange fee to the cost of an electronic debit transaction, Congress recognized that the debit card pricing system should be different from the check pricing system. These commenters argued that the Board should consider all costs that issuers incur for electronic debit transactions, regardless of whether the payor's bank would be able to recoup similar costs from the payee's bank in a check transaction.

Many issuers and networks suggested that the Board's interchange fee standards should account for the benefits merchants receive from accepting debit cards instead of checks. The benefits of debit cards to merchants that were cited include the payment guarantee; the avoidance of fees and other costs of handling checks;[32] faster availability of funds; faster check-out at the point-of-sale; increased sales value and volume; the ability to engage in certain types of transactions where checks are not practical (e.g., Internet); and resolution of disputes through network rules and mediation rather than through the legal system.[33]

Some issuer and network commenters suggested that the Board also consider the benefits to consumers of using debit cards instead of checks. Such benefits cited by the commenters included wide acceptance of debit cards by merchants, ease of use, and speed of transactions. More generally, some commenters noted that the increase in debit card use and decline in check use are indicative of greater value from debit cards to all parties. One network stated that interchange fee revenue has given issuers an incentive to innovate, allowing them to provide to merchants a product that is superior to checks.

[32] Cited costs of checks included per-item and batch deposit fees, check return fees, re-clearance fees, and an optional guarantee service.
[33] Some commenters argued that the benefits of debit cards over checks are also benefits of debit cards over cash.

One difference between electronic debit transactions and check transactions that commenters highlighted is the payment guarantee for electronic debit transactions. Numerous issuers and networks stated that, unlike checks, debit card transactions are guaranteed by issuers against insufficient funds in an account. These commenters stated that a comparable service for checks costs merchants 1.5 percent of the transaction value. Accordingly, several commenters argued that the Board should compare merchants' debit card acceptance costs to the cost of accepting a guaranteed check. Some commenters contended that failure to compensate issuers for the payment guarantee could decrease its availability.

The Board has considered the comments received and has revised its analysis of the comparison of check and electronic debit transactions, as set out below.

### 2. Comparison of check and electronic debit transactions

*Typical check transaction*.[34] Checks can be collected, presented, returned, and settled through an interbank system or through an intrabank system, in the case of checks deposited and drawn on the same bank (i.e., "on-us" checks). A typical check transaction is initiated by the payor (such as a consumer) writing a check drawn on the bank maintaining the payor's account to the order of a payee (such as a merchant). The payee receives as a payment the signed check and deposits the check with its bank for collection. The payee's bank has several choices in directing the presentment of the check to the payor's bank for payment. The payee's bank may (i) present the check for payment directly to the payor's bank, (ii) use a check clearing house, or (iii) use the services of an intermediate collecting bank, such as a Federal Reserve Bank or another correspondent bank.[35] Upon presentment, the payor's bank settles with the presenting

[34] *See* the discussion above providing an overview of the debit card industry for a description of the typical electronic debit transaction.
[35] Check clearing houses generally provide a facility or mechanism for banks to exchange checks for collection and return. The services provided by check clearing houses vary. Some merely provide the capability to exchange

bank (either the payee's bank or an intermediate collecting bank) for the amount of the check and debits the amount of the check from the account of the payor. In some cases, the payee's bank may also be the payor's bank, in which case the bank settles the check internally.

*Functional similarities.* There are a number of similarities between check and debit card payments. Both are payment instructions that result in a debit to the payor's account. Debit card payments are processed electronically, which is increasingly true for checks as well. For both check and debit card payments, merchants pay fees to banks, processors, or intermediaries to process the payments. Interbank settlement times are roughly similar for both payment types, with payments typically settling between banks on the same day, or one day after, the transaction is cleared. Settlement to the payee's account typically occurs within one or two days after the payee deposits the check or submits the debit card transaction to its bank.

*Dissimilarities.* As noted by many commenters, there are also important functional differences between the check and debit card payment systems. Some commenters argued that the debit card authorization, clearance, and settlement infrastructure has no direct corollary in the check system, and therefore, the comparison between check and debit card payment systems is inappropriate. The Board notes that EFTA Section 920(a)(4)(A) requires the Board to consider the functional similarities between checking transactions and electronic debit transactions. The Board recognizes that there are also important differences between the two types of transactions, including those discussed below.

*Closed network versus open system.* Debit card systems are "closed" systems (relative to check systems) in that both issuing and acquiring banks must join a network in order to accept and make payments. To accept debit cards, a merchant must select an acquirer and make

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checks. Others provide the capability to exchange between banks in electronic form. A check clearing house generally also facilitates settlement of the checks exchanged through it.

decisions as to the network(s) in which it will participate. Issuers and acquirers that are members of a network must establish a relationship with that network and agree to abide by that network's rules. These network rules include network-defined chargeback and liability allocation rules, network-defined processing and dispute handling requirements, and network fee schedules.[36]

The merchant's choice with regard to routing a debit card transaction is limited to the set of networks whose cards the merchant accepts and that are also enabled to process a transaction on the customer's card. Until the effective date of Regulation II, merchant transaction routing may be further limited if the card issuer or a network has designated network routing preferences on cards that are enabled on multiple networks. These issuer or network routing preferences may result in a transaction being routed to a network that imposes a higher fee on the acquirer (and hence the merchant) than if the payment were processed on another available network.

By contrast, the check system is an open system in which, as a practical matter, a merchant simply needs a banking relationship through which it can collect checks in order to be able to accept check payments from its customers. The payee's bank (i.e., the merchant's bank) need not join a network in order to collect a check. The rules governing checks are established by generally uniform state laws (e.g., the Uniform Commercial Code), the Expedited Funds Availability Act, and the Board's Regulation CC (12 CFR part 229). These laws and rules provide a common legal framework for all check system participants. The participants, however, may vary certain parts of those rules, such as by arranging to accept or send electronic images in place of the paper checks.

The routing of checks for collection is not limited in the same way as the routing of electronic debit transactions. A payee's bank is free to use its least costly option for collecting a

[36] In addition to the network rules, the EFTA establishes the basic rights, liabilities, and responsibilities of consumers who use electronic fund transfer services and of financial institutions that offer these services.

check.  Intermediary collecting banks generally compete on the basis of price and funds availability.  Typically price and availability vary within an intermediate collecting bank's service menu depending on the level of processing the collecting bank is required to do (e.g., whether the payee's bank sends checks in paper form or via electronic image) and depending on the time of day the checks are received.  If participants agree to send electronic images instead of the paper checks, the sending bank must have an agreement with the bank to which it is sending the image.

*Payment authorization and guarantee*.  Payment authorization is an integral part of the processing of a transaction on a debit card network.  As part of the payment authorization process, at the start of a transaction, a card issuer determines, among other things, whether the card is valid and whether there are sufficient funds to cover the payment.  Several commenters (predominantly issuers and their trade associations) emphasized that part of the approval includes a "payment guarantee," which refers to the issuers' agreement to fund a transaction authorized by the issuer regardless of whether customer funds are actually available at the time of the settlement of the transaction, subject to certain predefined chargeback rights.  These commenters argued that the cost of this "guarantee" is a settlement or authorization cost incurred by issuers when they pay acquirers funds to settle the transaction and the cardholder has insufficient funds in the account to cover the transaction.  Many merchant commenters, as well as issuers, stated that a debit card payment is provisional because the transaction may be charged back in certain circumstances, such as when it is later discovered that the transaction was not properly authorized by the customer.

By contrast, payment authorization is not an inherent part of the check collection process, and therefore the acceptance of a check by a merchant for payment does not include any

automatic "guarantee" that the check will be honored and the payment will be made. Merchants, however, can purchase check verification and guarantee services from various third-party service providers. These service providers offer varying levels of check guarantee and verification services that are structured in various ways. In a check "guarantee" service, a check guarantee provider may verify whether currently outstanding returned checks are associated with that payor or the checking account, as well as verify open/closed account status and valid/invalid routing and account numbers, although the service generally cannot verify the amount of funds in the payor's account.[37] If a check meets all of the guarantee service's criteria (such as no known outstanding bad checks drawn by the customer), the service authorizes acceptance by the merchant and accepts the risk of loss on the check.[38] If a check is subsequently returned unpaid, the merchant will be reimbursed by the check guarantee provider for the value of the returned check.

The merchant pays a fee for the check guarantee service. Based on available information, the Board understands that a check guarantee provider typically charges the merchant a percentage of the face value of all checks that are accepted, in addition to various other service charges. The fee structures vary by the service provider and also can vary by merchant type and perceived risk, but one commenter asserted that check guarantee services typically charge between 1.0 percent and 1.5 percent of the face amount of the check and a 25 cent per-check fee, as well as a monthly customer service fee.[39]

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[37] Based on information available to the Board, a check guarantee service requires extra steps at the time of a transaction and is not integrated into check processing the same way that the authorization and guarantee is integrated into the debit card transaction. Each check is entered into the system by inputting the check's MICR information on either a manual or automated basis. The merchant also enters customer identification information, such as the driver's license number. The guarantor then sends a return message to the merchant.

[38] The service provider may have exceptions to its guarantee and these exceptions may vary across service providers.

[39] *See, e.g.,* Comment letter from American Bankers Association, p. 7.

Another service offered is a check "verification" product, which does not include a guarantee. A check verification service may use database searches similar to a check guarantee service to approve or decline any given check transaction.[40] The check verification service, however, leaves the risk of an unpaid check with the merchant.

Various fees are charged for check verification services, and the fee structure and levels can vary by service provider and merchant. Based on information available to the Board, check verification services may charge a per transaction fee of about 25 cents with a $20 monthly minimum and may charge a monthly service fee.[41] Unlike the check guarantee services, the check verification services do not appear to also charge a fee based on the amount of the check.

*Payment of processing and collection costs*. In the check system, payments clear at par. When a presenting bank (either the payee's bank or an intermediary collecting bank) presents a check to the payor's bank, the payor's bank pays, and the presenting bank receives, the face value of the check (i.e., "par clearing"). The presenting bank typically does not pay a fee to the payor's bank in order to receive settlement for the check. In addition, the payor's bank does not pay fees to the presenting bank to receive check presentment unless the payor's bank has agreed to pay a fee to receive presentment electronically.[42] The payee's bank and any subsequent collecting bank incur costs to collect the check. A payor's bank incurs costs to be able to accept presentment of the check, to determine whether or not to pay the check, and to remit funds for settlement. One commenter indicated that these costs exceeded debit card processing costs. The

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[40] Some check verification services also provide the merchant with a reason for a decline, so the merchant can make a more informed decision as to whether to accept the check on a customer-by-customer basis. *See* http://www.ncms-inc.com/check-verification.aspx.

[41] *See* http://www.nobouncedchecks.com/SCAN-check.html

[42] If both the presenting bank and the payor's bank have voluntarily joined a check clearing house, they may pay fees to the clearing house.

payor's bank recoups some or all of these costs through fees it charges to its customers or the interest it earns on the customer's balances.

By contrast, in the debit card system, the merchant does not receive the full face value of the debit transaction. The merchant pays fees to its acquirer in the form of a discount on the value of each transaction for the services rendered in processing the transaction. The acquirer, in turn, pays an interchange fee to the issuing bank on each debit transaction, which is deducted from the amount of the debit card transaction in the daily net settlement calculations. The acquirer and issuer both pay fees to the network to process electronic debit transactions. As discussed in more detail below, the issuer incurs costs to authorize, clear, and settle debit card transactions, as well as other costs related to debit card programs. Likewise, the acquirer incurs costs to send authorization and clearing messages, as well as for interbank settlement and crediting the merchant's account.

*Payee deposit and availability*. A debit card transaction is initiated in an electronic format and sent electronically to the acquiring bank; the proceeds are then deposited in the merchant's bank account electronically and made available to the merchant in accordance with the agreement between the merchant and its acquirer.

With respect to paper checks, the check must be physically accepted by the merchant, and deposited in its bank and then sent through the check clearing process to the payor's bank. The proceeds of a typical check generally must be made available to the payee within one or two business days of deposit.[43] Banks may, and sometimes do, make check deposits available for withdrawal faster than the law requires.

Some merchants may take advantage of "remote deposit capture" services from their bank wherein a paper check is scanned to create an electronic image that is sent to the

[43] *See* Regulation CC, 12 CFR part 229.

merchant's bank electronically for deposit.[44] Remote deposit capture can decrease processing costs and improve customers' access to their deposits.[45] One commenter stated, however, that although some merchants may use remote deposit capture, many do not for a variety of reasons, including inconvenience, lack of eligibility, and cost.[46] Depository institutions charge a variety of fees for remote deposit capture, which may vary by depository institution and customer, but typically include a monthly service fee, a per-item fee, equipment lease/purchase fee, and various other fees. Some banks charge a monthly service fee and a fee for leasing the check scanner, although a customer may purchase a scanner.[47] A bank also may charge a per-item fee and a client set-up fee.[48]

*Ability to reverse transactions*. In the check system, there is a limited amount of time during which the payor's bank may return a check to the payee's bank. Specifically, the payor's bank must initiate the return by its "midnight deadline," which is midnight of the banking day after the check was presented to the payor's bank for payment.[49] After the midnight deadline passes, the payor's bank can no longer return the payment through the check payment system, although it may have legal remedies, such as warranty claims, outside the check collection system.[50] Such legal remedies may be available, for example, if a payor notifies its bank that the

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[44] Remote deposit capture was made practicable by the Check Clearing for the 21st Century Act (Check 21 Act), codified at 12 U.S.C. 5001 note.

[45] FFIEC, *Risk Management of Remote Deposit Capture* (Jan. 14, 2009). Certain risks, however, may be elevated with respect to remote deposit capture when compared to paper checks. For example, duplicate deposits, check alteration, and forged or missing indorsements may be more difficult to detect in remote deposit capture. *Id*. p.5.

[46] The elevated fraud risk may cause some banks to offer remote deposit capture only to creditworthy corporate customers with appropriate back office and control environments.

[47] FDIC Supervisory Insights (Summer 2009), *available at* http://www.fdic.gov/regulations/examinations/supervisory/insights/sisum09/primer.html

[48] *See, e.g.*, http://www.firstbankak.com/home/bs/remotedepositcapture/rdc_faq#15.

[49] UCC 4-104(a)(10) (definition of "midnight deadline").

[50] UCC 4-301 and 4-302. The payor's bank may have a warranty claim for a forged indorsement or a material alteration, but, except in limited circumstances, would not have a claim based on insufficient funds or forged drawer's signature.

check was altered or that the indorsements on the check were forged and does so reasonably promptly if the payor's bank provides statements to the payor.[51]

The debit card system provides a much longer time within which a transaction may be reversed through the payment card network, as opposed to warranty claims outside the payments system. Typically, the time period for initiating resolution of a disputed transaction through the network is around 60 days, but may be longer.[52] Payment card network rules permit certain disputed transactions to be resolved through the payment card network. Specifically, if a transaction was not authorized or is incorrect, payment card network rules generally provide that, depending on the facts and circumstances, (1) the transaction is guaranteed and the amount of the transaction must be absorbed as a fraud loss by the issuer; or (2) the transaction can be charged back to the merchant that accepted the electronic debit transaction.[53]

*Acceptance by merchants and consumers*. The use of debit cards by consumers is increasing, while the use of checks is decreasing.[54] The increase of electronic payments and the decline of checks can be attributed to technological and financial innovations that influence the payment choices of consumers and businesses. Commenters (predominantly issuers, networks, and consumers) provided other reasons for these trends, such as ease and speed of the debit card transaction and the fact that customers do not need to leave a physical copy of their names and addresses with the merchant after a debit card transaction, as they would with checks. Many issuer and network commenters asserted that merchants also are increasingly accepting debit cards because debit cards increase the amount of money consumers spend at the point of sale.

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[51] UCC 4-406.
[52] The Board's Regulation E (implementing other provisions of the EFTA) states that a consumer has 60 days to dispute the transaction as unauthorized or incorrect from the date that the consumer's depository institution posts an electronic debit transaction to the consumer's account and sends a statement to the consumer. 12 CFR 205.11(b).
[53] Morrison & Foerster comment letter, p.10.
[54] Between 2006 and 2009, check transactions decreased by an average of 7.1% annually and debit card transactions increased by an average of 14.8% annually. *See* The 2010 Federal Reserve Payments Study.

In addition, debit transactions are used in many situations that do not readily lend themselves to the use of checks, such as purchases made over the Internet or telephone, online recurring payments, vending machine transactions, self-service checkout purchases, and purchases at automated gas pumps. Also, foreign checks are not nearly as widely accepted by U.S. merchants as are debit cards issued by institutions in foreign countries. Consumers generally may use their debit cards at locations beyond their local area, regardless of the location of the card issuer.

As required by EFTA Section 920(a)(4)(A), the Board has taken the similarities between the functionality of electronic debit transactions and check transactions into account in establishing the standards for interchange fees under Section 920(a). The functional similarities between these two types of transactions can be understood only by considering the differences between them as well. Accordingly, the Board has also, in fulfilling the mandate in Section 920(a)(4)(A) and in the exercise of its discretion under Section 920(a), considered the differences between these two types of transactions in establishing standards for assessing whether interchange fees are reasonable and proportional to cost, as discussed below in the interchange fee standards section.

## III. Summary of proposal and comments

### A. Summary of proposal

The Board requested comment on two alternative standards for determining whether the amount of an interchange transaction fee is reasonable and proportional to the cost incurred by the issuer with respect to the transaction. Under Alternative 1, an issuer could comply with the standard for interchange fees by calculating its allowable costs and ensuring that, unless it accepts the safe harbor as described below, it did not receive through any network any

interchange fee in excess of the issuer's allowable costs. An issuer's allowable costs would be those costs that both are attributable to the issuer's role in authorization, clearance, and settlement of the transaction and vary with the number of transactions sent to an issuer within a calendar year (variable costs). The issuer's allowable costs incurred with respect to each transaction would be the sum of the allowable costs of all electronic debit transactions over a calendar year divided by the number of electronic debit transactions on which the issuer received or charged an interchange transaction fee in that year. The issuer-specific determination in Alternative 1 would be subject to a cap of 12 cents per transaction, regardless of the issuer's allowable cost calculation. Alternative 1 also would permit an issuer to comply with the regulatory standard for interchange fees by receiving or charging interchange fees that do not exceed the safe harbor amount of 7 cents per transaction, in which case the issuer would not need to determine its allowable costs.

Under Alternative 2, an issuer would comply with the standard for interchange fees as long as it does not receive or charge a fee above the cap, which would be set at an initial level of 12 cents per transaction. Each payment card network would have to set interchange fees such that issuers do not receive or charge any interchange fee in excess of the cap amount.

The Board requested comment on two general approaches to the fraud-prevention adjustment framework and asked several questions related to the two alternatives. One approach focused on implementation of major innovations that would likely result in substantial reductions in total, industry-wide fraud losses. The second approach focused on reasonably necessary steps for an issuer to maintain an effective fraud-prevention program, but would not prescribe specific technologies that must be employed as part of the program. The Board did not propose a specific

amount as an adjustment to the amount of an interchange fee for an issuer's fraud-prevention costs.

As provided in EFTA Section 920, the Board proposed to exempt from the interchange fee restrictions issuers that, together with affiliates, have assets of less than $10 billion, and electronic debit transactions made using either debit cards issued under certain government-administered programs or certain reloadable prepaid cards.

In order to prevent circumvention or evasion of the limits on the amount of interchange fee that issuers may receive or charge with respect to electronic debit transactions, the Board proposed to prohibit an issuer from receiving net compensation from a network for debit card transactions, excluding interchange transaction fees. For example, the total amount of compensation provided by the network to the issuer, such as per-transaction rebates, incentives, or payments, could not exceed the total amount of fees paid by the issuer to the network.

The Board requested comment on two alternative approaches to implementing the statute's required rules that prohibit network exclusivity. Under Alternative A, an issuer or payment card network may not restrict the number of payment card networks over which an electronic debit transaction may be processed to fewer than two unaffiliated networks. Under this alternative, it would be sufficient for an issuer to issue a debit card that can be processed over one signature-based network and one PIN-based network, provided the networks are not affiliated. Under Alternative B, an issuer or payment card network may not restrict the number of payment card networks over which an electronic debit transaction may be processed to fewer than two unaffiliated networks for each method of authentication the cardholder may select. Under this alternative, an issuer that used both signature- and PIN-based authentication would

have to enable its debit cards with two unaffiliated signature networks and two unaffiliated PIN networks.

The Board proposed to prohibit issuers and payment card networks from restricting the ability of a merchant to direct the routing of electronic debit transactions over any of the networks that an issuer has enabled to process the electronic debit transactions. For example, issuers and payment card networks may not set routing priorities that override a merchant's routing choice. The merchant's choice, however, would be limited to those networks enabled on a debit card. In keeping with EFTA Section 920, no exemption was provided from the network exclusivity and routing provisions for small issuers or for debit cards issued pursuant to certain government-administered programs or certain reloadable general-use prepaid cards.

**B. Summary of comments**

The Board received comments on the proposed rule from approximately 11,570 commenters. Of these commenters, approximately 7,080 were depository institutions or represented depository institutions (including trade groups, outside counsel, and consultants), approximately 3,020 were merchants or represented merchants (including trade groups, outside counsel, and consultants), 9 were payment card networks, 23 were payment processors, approximately 1,340 were individual consumers or represented consumer groups, 35 were members of Congress or represented government agencies, and 54 were other interested parties. Approximately 8,300 of the commenters submitted one of 17 form letters, and one letter was submitted on behalf of over 1,600 merchant commenters.

**1. Overview of comments received**

Merchants, their trade groups, and some consumers supported the Board's proposal and argued that the proposal would lower the current interchange fees (the savings of which could be

passed on to consumers as lower retail prices), increase transparency in the system, and increase competition by prohibiting exclusivity arrangements and enabling merchant-routing choice. By contrast, issuers, their trade groups, payment card networks, and some consumers opposed the proposal for a range of reasons, including concern that it would decrease revenue to issuing banks; result in increased cardholder fees or decreased availability of debit card services; reduce benefits to merchants when compared to other forms of payment; not provide a workable exemption for small issuers; and stifle innovation in the payment system, among other things.

*Interchange fee standards*. As between proposed Alternative 1 and proposed Alternative 2, merchants supported the more issuer-specific Alternative 1, arguing that issuer-specific fees would be a proxy for fees in a competitive issuer market place and that many covered issuers had per-transaction authorization, clearance, and settlement costs significantly below the proposed 12-cent cap. Likewise, merchants supported lowering the cap, some suggesting 4 cents (i.e., the average per-transaction allowable costs across all transactions and issuers). Merchants argued that the proposed cap would allow some issuers to receive an interchange fee significantly higher than the proposed allowable costs of authorization, clearance, and settlement. Merchants overwhelmingly supported the Board's proposal to limit allowable costs to the variable costs of authorization, clearance, and settlement.

Issuers and networks urged the Board to adopt a more flexible approach to the standards by prescribing guidelines rather than a cap. Issuers typically favored the stand-alone cap in Alternative 2 over Alternative 1. Issuers suggested raising the safe harbor up to a level that permits a "substantial majority" of issuers to avail themselves of it. Issuers and networks supported raising the cap and safe harbor by expanding the allowable cost base to include such

costs as the payment guarantee costs, fraud losses, network processing fees, customer service costs, the costs of rewards, fixed costs, and a return on investment.

*Fraud-prevention adjustment*. Although there was not agreement on which approach to pursue, commenters generally agreed that the Board should not mandate use of specific technologies. Merchants generally favored the paradigm-shifting approach.[55] By contrast, issuers of all sizes and payment card networks preferred the non-prescriptive approach that would allow issuers to have the flexibility to tailor their fraud-prevention activities to address most effectively the risks they faced and changing fraud patterns. Among commenters, there was a general consensus that the fraud-prevention adjustment should be effective at the same time as the interchange fee standard—either on July 21, 2011, or at a later date as suggested by some commenters. This issue is addressed in the companion notice adopting an interim final rule providing a fraud-prevention adjustment.[56]

*Exemptions*. Many issuers were concerned that the exemptions, and in particular the small-issuer exemption, would not be effective because all networks might not institute a two-tier fee structure or might not be able to implement such a structure by July 21, 2011. Additionally, issuers argued that, even if networks institute a two-tier fee structure, market forces and merchant routing choice would place downward pressure on interchange fees over time. Some issuers suggested the Board require that networks implement a two-tier fee structure. Other commenters suggested the Board initially monitor implementation of two-tier fee structures (perhaps by requiring networks to report to the Board on whether and how they have implemented an interchange fee differential).

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[55] Merchants proposed a framework where an issuer receives an adjustment only if both the merchant and issuer use an eligible low-fraud technology (i.e., one that reduces fraud losses below PIN debit levels).
[56] *See* companion interim final rule published separately in the *Federal Register*.

Additionally, some issuers and prepaid industry commenters supported exempting Health Savings Account (HSA), Flexible Spending Account (FSA), Health Reimbursement Account (HRA), and Qualified Transportation Benefit (QT) cards from the interchange fee standard because they believe Congress did not intend to cover such cards. By contrast, some merchant groups argued that HSA, FSA, HRA, or QT cards do not qualify for the exemption for reloadable prepaid cards because such cards typically are not reloadable and the funds are held in employer accounts for the benefit of the employee or held by the cardholder him or herself.

*Circumvention and evasion.* Issuers generally agreed that circumvention or evasion should be determined on a case-by-case basis based on the facts and circumstances. Issuers believed that the proposed net compensation approach was overly broad because it considered compensation for "debit card-related activities," rather than merely debit card transactions. Merchants, however, supported the consideration of compensation for non-debit card programs when the compensation is tied to debit card activities and chargebacks. Merchants also urged the Board to prevent forms of circumvention or evasion other than net compensation, such as increasing merchant network fees concurrently with decreases in issuer network fees and issuers' adjusting their products to avoid the final rule's interchange fee limits.

*Network exclusivity and routing provisions.* Issuer and network commenters preferred the proposal to require two unaffiliated networks for processing without regard to the method of authentication (Alternative A) because the commenters believed that Alternative A was most consistent with the statutory language. These commenters also argued that Alternative B, which would require at least two processing alternatives for each authentication method, would impose significant operational burdens with little consumer benefit. In particular, issuers and networks asserted that Alternative B, when coupled with merchant routing choice, would cause consumer

confusion and/or decrease consumer benefits. Moreover, these commenters asserted that Alternative B could stifle innovation, as networks and issuers would have less incentive to develop new authentication technologies, which they would have to ensure could be implemented on at least two networks.

Merchants preferred Alternative B because they believed that Alternative B is consistent with the statute and would provide the most routing choice and the most market discipline on interchange and network fees. They noted that, under Alternative A, once the consumer has chosen the method of authentication, the merchant may not have a choice over which network to route the transaction. Merchants also believed that Alternative B would promote competition for signature debit, whether from PIN networks or other new entrants.

Several commenters suggested that the Board invoke EFTA Section 904(c) to exempt small issuers and prepaid cards from the network exclusivity and routing rules. Several prepaid issuers and a processor commented that, if a prepaid card is not enabled for both signature and PIN, such cards should not be required to have two signature networks, which would require substantial operational restructuring by various debit card participants to accomplish. Several issuers and prepaid industry group commenters stated that because of restricted functionality of HSA, FSA, HRA, and QT cards, such cards cannot be used on a PIN network without significant cost and operational changes, partly because satisfying certain Internal Revenue Service (IRS) requirements is currently possible only over signature networks. Additionally, commenters noted that enabling two signature networks may not be operationally practical at this time.

*Scope*. The Board received comments on the application of the proposed rule to three-party systems, ATM transactions, and emerging payment technologies. The majority of commenters recognized that three-party systems do not charge explicit interchange fees (rather,

they charge a merchant discount), but were concerned that exempting three-party systems from the interchange fee standards would create an uneven playing field. Even commenters favoring coverage of three-party systems recognized, however, the circuitous routing that would result from subjecting these systems to the network exclusivity and routing provisions. A three-party system urged the Board to exempt such systems from the exclusivity and routing provisions.

With respect to ATM transactions, almost all comments received on the issue agreed that interchange fees on ATM transactions should not be covered because they flow from the issuer to the ATM operator. Although representatives of ATM operators supported applying the network exclusivity and routing rules to ATM transactions, issuers and networks opposed applying the network exclusivity and routing rules to ATM transactions because of different economic incentives for ATM transactions.

Issuer, network, and merchant commenters generally supported including emerging payments technologies under both the interchange fee standards and network exclusivity and routing rules so as to not create an unfair benefit for emerging payments networks. Some networks and issuers were concerned that applying the interchange fee restrictions and network exclusivity and routing provisions to emerging payment systems and means of authentication would stifle innovation, leading to reduced competition in the payments market. Other commenters suggested exempting emerging payment systems either during their pilot stage or for a specified period after they begin processing transactions. Other commenters were concerned that some "emerging payments systems" were not truly emerging, and therefore exempting them would create an uneven playing field.

**2. Other general comments**

The Board received numerous comments that related to the proposed rule and EFTA Section 920 more generally. Numerous commenters opposed any government regulation of interchange fees (and prices generally) and stated that the free market should determine interchange fee levels. Some of these commenters argued that price and quality competition in the debit card market currently is strong, as well as transparent. These commenters believed that the government should impose price controls only where a market is monopolized or is otherwise demonstrably not functioning properly. Many of these commenters stressed the potential negative or unintended consequences of government price controls. Many commenters were further concerned that government price controls would prevent lower-cost providers from entering the market.

Numerous commenters requested that the Board either take more time to consider the issue or not adopt interchange fee restrictions. These commenters thought that further study and debate were needed because of the lack of study and debate by Congress prior to passing EFTA Section 920. Several commenters stated that the Board should have conducted hearings, debates, and impact analyses prior to proposing a rule, and encouraged the Board to further study the issue rather than adopting a final rule. One commenter did not believe the statute provided the Board with sufficiently intelligible standards to promulgate rules; rather, the commenter argued that several policy judgments remained for Congress to make. Other commenters did not believe that government intervention was required at this time. Rather, a few commenters believed that market competition from alternative payment forms (e.g., mobile) would put downward pressure on interchange fees. Another commenter did not believe any interchange fee regulation would be necessary if there were no network-imposed restraints on merchant-customer interactions.[57]

[57] Other commenters suggested that the government supply payment card network services or that the Board reform money transmitter laws rather than regulating interchange fees.

### 3. Consultation with other agencies

EFTA Section 920(a)(4)(C) directs the Board to consult, as appropriate, with the Comptroller of the Currency, the Board of Directors of the Federal Deposit Insurance Corporation, the Director of the Office of Thrift Supervision, the National Credit Union Administration Board, the Administrator of Small Business Administration, and the Director of the Bureau of Consumer Financial Protection in the development of the interchange fee standards. Board staff consulted with the staff of these agencies throughout the rulemaking process on all aspects of the proposed rule including the interchange fee standards, the role of supervisors in determining compliance with these standards, the small-issuer exemption, the potential effects on consumers (both banked and unbanked) and merchants (both small and large), the two proposed approaches to a fraud-prevention adjustment, possible means of circumvention and evasion of the interchange fee standards (through network fees, compensation, change in account structure, or otherwise), and the possible impact of the prohibitions against network exclusivity arrangements and routing restrictions. Many of these agencies submitted formal comment letters, raising many of the same issues addressed by other commenters and discussed above.

## IV. Summary of final rule

The Board has considered all comments received and has adopted Regulation II (Debit Card Interchange Fees and Routing).

For the interchange fee standard (set forth in § 235.3), the final rule adopts a modified version of proposed Alternative 2 (stand-alone cap) and provides that an issuer may not receive or charge an interchange transaction fee in excess of the sum of a 21-cent base component and 5 basis points of the transaction's value (the *ad valorem* component). The interchange fee standard

is based on certain costs incurred by the issuer to effect an electronic debit transaction ("allowable costs" or "included costs"). The standard is based on data collected by the Board through its survey of covered issuers and reflects comments received from many parties. Issuer costs that are incurred to effect a transaction include the following costs related to authorization, clearance, and settlement of a transaction: network connectivity; software, hardware, equipment, and associated labor; network processing fees; and transaction monitoring. Several other costs that may be incurred in effecting a transaction, such as costs related to customer inquiries and the costs related to rewards programs, were not included for various reasons explained below. As noted above, an allowance for fraud losses is also included as an issuer cost incurred to effect a transaction. The Board did not include other costs not incurred to effect a particular transaction. Issuer costs that are not incurred in effecting a transaction include costs of corporate overhead (such as senior executive compensation); establishing the account relationship; card production and delivery; marketing; research and development; and network membership fees.

With respect to the fraud-prevention adjustment, the interim final rule (published separately in the *Federal Register*) adopts the more general, less prescriptive approach to standards regarding the eligibility of an issuer to receive the adjustment and sets the adjustment at 1 cent per transaction.

The final rule prohibits circumvention and evasion of the interchange fee standard, as well as an issuer receiving net compensation from a payment card network.

The final rule exempts from the interchange fee standard issuers that, together with affiliates, have assets less than $10 billion, debit cards issued pursuant to certain government-administered programs, and certain reloadable general-use prepaid cards. The final rule provides that the Board will publish a list of annually of institutions above and below the small issuer

exemption asset threshold to facilitate the identification of exempt institutions. In addition, the Board will annually collect and publish information regarding interchange fees collected by networks and received by exempt and non-exempt issuers and transactions to allow monitoring of the effectiveness of the exemption for small issuers.

With respect to network exclusivity, the final rule adopts Alternative A (i.e., two unaffiliated networks for each transaction). The final rule also adopts the prohibitions on routing restrictions in the proposed rule.

The final rule's definition of "payment card network" excludes three-party systems because they are not payment card networks that route transactions within the terms of the statute. The final rule's definition of "account" excludes accounts established pursuant to *bona fide* trust arrangements.

Various modifications throughout the rule were made in response to comments and additional information available to the Board. The final rule and the modifications adopted are explained more fully below.

**Section-by-section analysis**

**I. Authority and purpose**

The Board proposed to set forth the authority and purpose of Regulation II in § 235.1. The Board received no comments on proposed § 235.1. The Board, however, made two revisions to that section. First, the Board has revised the authority citation in proposed § 235.1(a) to reflect the section of the United States Code in which EFTA Section 920 is codified. Second, the Board has revised § 235.1(b) to state that Regulation II also implements standards for receiving a fraud-prevention adjustment.[58]

**II. Definitions**

[58] *See* the companion interim final rule published separately in the *Federal Register*.

### A. Section 235.2(a) – Account

The Board proposed to define "account" to mean "a transaction, savings, or other asset account (other than an occasional or incidental credit balance in a credit plan) established for any purpose and that is located in the United States." The proposed definition included both consumer and business accounts, as well as accounts held pursuant to a *bona fide* trust arrangement.

#### 1. Summary of comments

The Board received comments on its proposed definition of "account" related to the proposed inclusion of business-purpose accounts and *bona fide* trust arrangements. A few commenters suggested that the Board exclude business accounts from the definition of "account" because the EFTA applies only to consumer accounts. These commenters contended that the Board should not infer congressional intent to include business debit cards from the parenthetical in EFTA Section 920(c)(2) (definition of "debit card"), which states that the purpose of the account being debited is irrelevant. In support of this argument, one commenter noted that business accounts and consumer accounts differ both in the nature of purchases and the account structure (e.g., business accounts may have multiple employees on a single account). Other commenters stated that the Board has not previously expanded the definition of "account" in its Regulation E; these commenters saw no reason to expand the term's scope at this time.[59]

A few commenters urged the Board to exclude *bona fide* trust arrangements from the definition of "account" because EFTA Section 903(2) excludes *bona fide* trusts from the definition of "account." These commenters asserted that a *bona fide* trust arrangement is not a "purpose" of the account; therefore, the parenthetical in Section 920(c)(2) does not affect the

[59] These commenters stated that the purpose of both the EFTA and the Dodd-Frank Act was consumer protection and that including business accounts under the scope of rule was contrary to the purpose behind EFTA Section 920.

EFTA's general exclusion of *bona fide* trust arrangements. Additionally, a few commenters expressed concern that including *bona fide* trust arrangements in the definition of "account" could result in different treatment of health savings accounts (HSAs) and other similar accounts that are structured as *bona fide* trusts (proposed to be subject to the fee standards) and those that are structured as reloadable, general-use prepaid cards (which would be exempt), which could, a commenter contended, create confusion for cards that access both types of HSAs and similar accounts. Finally, one commenter suggested that payroll cards be excluded from the definition of "account."

**2. Analysis and final rule**

EFTA Section 903(2) defines the term "account" to mean "a demand deposit, savings, deposit, or other asset account (other than an occasional or incidental credit balance in an open credit plan as defined in section 103(i) of [the EFTA]), as described in regulations of the Board, established primarily for personal, family, or household purposes, but such term does not include an account held by a financial institution pursuant to a *bona fide* trust agreement."[60] Section 920(c)(2) of the EFTA, however, defines the term "debit card" to mean a card that may be used "to debit an asset account (*regardless of the purpose for which the account is established*) . . . ."[61] Some commenters encouraged the Board to disregard the parenthetical in Section 920(c)(2) as inconsistent with Section 903(2)'s definition that applies throughout the EFTA. Doing so, however, would render the parenthetical mere surplusage, contrary to principles of statutory construction. The Board notes that Regulation E and this rule have different scopes because Section 920 has differing definitions and scope of coverage than the rest of the EFTA.

[60] 15 U.S.C. 1693a(2).
[61] 15 U.S.C. 1693o-2(c)(2) (emphasis added).

The Board interprets the parenthetical as removing the limitation in EFTA Section 903(2) that applies the "account" definition only to accounts used for consumer purposes. Thus, the Board has adopted its proposal to include accounts used for business purposes as "accounts" under Section 920. Accordingly, § 235.2(a) will continue to include transaction, savings, and other asset accounts, regardless of the purpose for which the account was established. This definition of "account" is limited to this part and does not extend to other rules that implement other provisions of the EFTA.

The Board agrees with the commenters that a trust is a type of account structure rather than a purpose (such as a business purpose or personal purpose) for which the account is held. Therefore, the Board has revised its proposed definition of "account" to exclude *bona fide* trusts, consistent with EFTA Section 903(2). For purposes of Regulation E, the Board has stated that whether an agreement is a *bona fide* trust agreement is a question of state or other applicable law.[62] The Board believes a similar approach is warranted under this rule. In general, *bona fide* agreements or arrangements are those done in good faith and not merely a device to evade a law.[63] Accordingly, the Board has revised the definition of "account" to exclude accounts held under *bona fide* trust agreements that are excluded from the definition of "account" under EFTA Section 903(2) and rules prescribed thereunder. The Board has added comment 2(a)-2 to clarify that whether a trust arrangement is *bona fide* is a matter of state or other applicable law and that accounts held under custodial agreements that qualify as trusts under the Internal Revenue Code are considered to be held in trust arrangements.

With respect to excluding HSAs and similar accounts, many commenters pointed to statements by members of Congress regarding their intent that cards used in connection with

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[62] 12 CFR part 205, Supplement I, par. 2(b)(2). An account held under a custodial agreement that qualifies as a trust under the Internal Revenue Code is considered to be a trust agreement for purposes of Regulation E.
[63] *See, e.g.*, 44B Am. Jur. 2d. Interest and Usury § 14.

flexible spending accounts (FSAs), HSAs, and health reimbursement accounts (HRAs) not be subject to either the interchange fee standards or the network exclusivity and routing provisions.[64] Other commenters stated that HSAs and other similar accounts are not "asset accounts," but are employer-sponsored and administered arrangements under which employees have an unsecured right to reimbursement for certain health-care-related purchases. The commenters explained that the employer in such arrangements is not required to keep funds for the reimbursements or to fund any specified account. Some commenters stated that HSAs and other similar accounts often are structured as *bona fide* trusts.

The language in EFTA Section 920 does not provide for any exceptions to the section's provisions based on the purpose for which an account was established; moreover, Section 920(c)(2) defines "debit card" as including cards that may be used to debit an account "regardless of the purposes for which the account was established." Therefore, the Board does not believe that the statute exempts debit cards that access HSAs and other similar accounts solely because such accounts are established for health care-related purposes. Such cards and accounts, however, may be otherwise exempt from the Board's interchange fee standards if they qualify for another exemption. For example, as commenters noted, some HSAs and other similar accounts are structured as *bona fide* trust arrangements. Cards that access these HSAs would be exempt from the requirements of this part because they do not access "accounts," as the term is defined in § 235.2(a). In addition, some cards that access HSAs and other similar accounts are structured like prepaid cards where funds are held in an omnibus account (which is considered an "account" under § 235.2(a)) and the employee may access the funds using a prepaid card. Provided these cards are structured in such a way that qualifies them for the reloadable, general-

[64] *See* 156 Cong. Rec. S5927 (statements of Sen. Dodd) (2010); 156 Cong. Rec. H5225-26 (statements of Rep. Larson and Rep. Frank) (2010).

use prepaid card exemption in the statute, these cards used to access HSAs and similar accounts will be exempt from the rule's interchange fee standards. *See* discussion of § 235.5(c). These cards, however, will be subject to the rule's network exclusivity and routing provisions. *See* discussion of delayed effective date related to § 235.7.

Finally, the Board has adopted a definition of "account" that restricts the term to those accounts located in the United States. The Board received no comment on this part of the proposal. The Board, however, has made clarifying revisions to proposed comment 2(a)-2, now designated as 2(a)-3.

**B. Section 235.2(b) – Acquirer**

The Board proposed to define "acquirer" to mean "a person that contracts directly or indirectly with a merchant to provide settlement for the merchant's electronic debit transactions over a payment card network." The Board proposed to exclude processors from the definition of "acquirer." The Board received one comment on the proposed definition. This commenter supported a definition that limited acquirers to those entities that move money, and excluded processors, gateways, and independent sales organizations ("ISOs").[65]

The Board has determined to adopt § 235.2(b) as proposed, but has made minor revisions to proposed comment 2(b)-1 to clarify that an acquirer settles for the transaction with the issuer, rather than with the network itself. Although the network calculates net settlement amounts for issuers and acquirers, settlement occurs between the issuer and acquirer. The Board also revised comment 2(b)-1 to clarify that in some circumstances, processors may be considered payment card networks. *See* discussion of §§ 235.2(m) and 235.2(o).

**C. Section 235.2(c) – Affiliate**

[65] A gateway is an entity that connects multiple networks. Merchants may sign-up with a gateway to enable them to accept debit cards and the gateway acts as a switch for the merchants to access multiple networks. ISOs provide merchant- and cardholder-acquisition services, including deploying point-of-sale ("POS") terminals.

The Board proposed to define the term "affiliate" to mean "any company that controls, is controlled by, or is under common control with another company." The proposed definition incorporated the definition of "affiliate" in EFTA Section 920(c)(1). The term "affiliate" is relevant for two purposes in this part: determining which issuers are considered "small" for purposes of the small-issuer exemption, and determining which prepaid cards are considered "general-use."[66] In proposed comment 2(f)-5, the Board explained that "two or more merchants are affiliated if they are related by either common ownership or by common corporate control," and that, for purposes of this rule, the Board considered franchises to be under common corporate control "if they are subject to a common set of corporate policies or practices under the terms of their franchise licenses."

The Board received one comment suggesting that the Board use a consistent definition of "affiliate" for both the small issuer exemption and for general-use prepaid cards, expressing a preference for the control test set forth in the proposed definition of "control." This commenter expressed concern that requiring only common ownership, and not common control, could result in the exclusion of closed-loop cards accepted at merchants that are not truly affiliated.

The Board has considered the comment and does not believe that "affiliate" is defined inconsistently in the small-issuer and general-use prepaid card contexts. First, proposed comment 2(f)-5 is consistent with the measure for "control" in proposed § 235.2(e)(3): "[t]he power to exercise, directly or indirectly, a controlling influence over the management or policies of the company, as the Board determines." Second, the acceptance of a "closed-loop" card is not sufficient to cause merchants to be affiliated as the term is defined in this rule. For example,

[66] Under EFTA Section 920(a)(6), an issuer is considered "small" if it, together with its affiliates, has assets of less than $10 billion. 15 U.S.C. § 1693o-2(a)(6). EFTA Section 920 incorporates the definition of "general-use prepaid cards" from the Credit CARD Act of 2009, which defines "general-use prepaid cards" as those cards that, among other things, are redeemable at multiple, unaffiliated merchants. 15 U.S.C. § 1693l-1(a)(2)(A).

closed-loop cards may be accepted at a group of merchants that are not subject to a common controlling influence over their management and policies. Such cards are considered "general-use prepaid cards" (*see* discussion of § 235.2(i)) and would not be subject to the interchange fee standards if they satisfied the criteria for exemption in § 235.5(c). These closed-loop cards, however, would not be excluded from the network exclusivity and routing provisions as would cards accepted only at affiliated merchants. If the merchants were affiliated, the prepaid card would not be considered "general-use" and would be excluded from Section 920's definition of "debit card."

Both the EFTA's definition and the proposed definition of "affiliate" were silent as to whether affiliated companies included companies located outside the United States. One commenter suggested that the term be limited to U.S. affiliates. The statutory language is silent on this point, and the Board believes it is appropriate to consider the total resources available to an issuer when determining whether it is "small."[67] Accordingly, the Board has adopted the definition of "affiliate" in proposed § 235.2(c). The Board has added language to comment 2(c)-1 to clarify that the term "affiliate" includes any U.S. and foreign affiliate.

**D. Section 235.2(d) – Cardholder**

The Board proposed to define "cardholder" to mean "the person to whom a debit card is issued." The Board did not receive any comments on the proposed definition of "cardholder" and has adopted § 235.2(d) as proposed.

**E. Section 235.2(e) – Control**

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[67] The Board considered the assets of both U.S. and non-U.S. affiliates when determining which issuers to survey. The Board computed assets using the Consolidated Financial Statements for Bank Holding Companies (FR Y-9C; OMB No. 7100-0128), the Consolidated Reports of Condition and Income (Call Reports) for independent commercial banks (FFIEC 031 & 041; OMB No. 7100-0036) and for U.S. branches and agencies of foreign banks (FFIEC 002; OMB No. 7100-0032), the Thrift Financial Reports (OTS 1313; OMB No. 1550-0023) for thrift holding companies and thrift institutions, and the Credit Union Reports of Condition and Income (NCUA 5300/5300S; OMB No. 3133-0004) for credit unions. The ownership structure of banking organizations was established using the FFIEC's National Information Center structure database.

The Board proposed to define "control" as it is defined in existing Board regulations.[68] The Board did not receive any comments specifically on the proposed definition of "control," although the Board received comments on the definition of "affiliate," discussed above. The Board has adopted § 235.2(e) as proposed.

**F. Section 235.2(f) – Debit card**

**1. Summary of proposal and comments**

EFTA Section 920(c)(2) defines the term "debit card" as "any card, or other payment code or device, issued or approved for use through a payment card network to debit an asset account (regardless of the purpose for which the account is established), whether authorization is based on signature, PIN, or other means" and as including general-use prepaid cards (as defined in EFTA Section 915(a)(2)(A)) but excluding paper checks. The proposed definition incorporated the statutory definition with some clarifying changes.

The proposed definition of "debit card" had three parts. First, the proposed definition included "any card, or other payment code or device, issued or approved for use through a payment card network to debit an account, regardless of whether authorization is based on signature, personal identification number (PIN), or other means, and regardless of whether the issuer holds the account." Second, the proposed definition included "any general-use prepaid card."[69] Finally, the proposed definition excluded (1) any cards, or other payment codes or devices, that are redeemable only at a single merchant or an affiliated group of merchants; (2) checks, drafts, or similar paper instruments, or electronic representations thereof; and (3) account numbers when used to initiate an ACH transaction to debit a person's account. Additionally, the

[68] *See* Regulation Y (Bank Holding Companies and Change in Bank Control), 12 CFR 225.2(e) and Regulation P (Privacy of Consumer Financial Information), 12 CFR 216.3(g).
[69] See discussion of § 235.2(i) for a discussion of the term "general-use prepaid card." Comment 2(i)-7 explains that store cards are not included in the term "debit card" under this rule.

proposed commentary explained that the term "debit card" included deferred debit cards (where the transaction is posted to the cardholder's account but not debited for a specified period of time) and decoupled debit cards (where the issuer does not hold the account being debited). The Board received several comments about which cards, or other payment codes or devices, should or should not be considered debit cards under this part. Many of these comments related to the proposed commentary and are summarized and analyzed below.

### 2. Card, or other payment code or device

Proposed comment 2(f)-1 explained that the phrase "card, or other payment code or device" includes cards, codes, and devices in physical and non-physical (i.e., electronic) form. The Board received three comments regarding which "payment codes" should be included or excluded from the definition of debit card. One issuer requested that the Board clarify that "payment code" does not include one-time passwords (or other numbers) generated for purposes of authenticating the cardholder, provided such passwords/numbers are not used in lieu of an account number. The Board does not believe that a one-time password or other number used for purposes of authentication and in addition to the card, or other payment code or device, is itself a "payment code or device." In that case, the passwords/numbers function like PINs or signatures. Therefore, the Board has revised proposed comment 2(f)-1 to clarify that cards, or other payment codes or devices, are not debit cards if used for purposes of authenticating the cardholder and used in addition to a card, or other payment code or device.

One commenter requested that the Board exclude account numbers from the definition of debit card if the account numbers are used to access underlying funds held in a pooled account, but where the underlying funds do not move (i.e., the transaction is a general ledger entry). By contrast, another commenter suggested that such use of account numbers be included in the

definition of debit card because the account numbers are used to debit "asset accounts." As discussed in greater detail below in relation to § 235.2(m), account numbers, or other payment codes or devices, that are used only to initiate general ledger transactions are not issued or approved for use through a payment card network because the entity receiving the transaction information and data is not routing the information to an unaffiliated entity. Accordingly, even if the account number is used to debit an "account," the account number is not a debit card because it was not issued or approved for use through a payment card network.

### 3. Deferred debit cards

Proposed comment 2(f)-2 explained that deferred debit cards are included within the proposed definition of "debit card." Like other debit cards, deferred debit cards can be used to initiate direct debits to the cardholder's account, but the issuer may not debit the funds until after a pre-arranged period of time (e.g., two weeks) after posting the transaction to the cardholder's account. During this time period, the funds typically are unavailable to the cardholder for other purposes, although the cardholder may accrue interest on the funds until the issuer debits the account.

The Board did not receive any comments opposed to including deferred debit cards within its definition of "debit card," but did receive a few comments on the proposed deferral time period, as well as comments seeking clarification as to which cards qualified as deferred debit cards. Two commenters suggested that the Board exclude from the definition of "debit card" any cards where settlement to the cardholder's account is deferred 14 days or more after the transaction because a 2003 network/merchant settlement treats such cards as charge or credit cards.[70] The Board has considered these comments and determined not to revise proposed

[70] *See* MasterCard comment letter, Appendix C.

comment 2(f)-2 to limit deferred debit cards to those cards where the issuer settles the transaction with the cardholder within 14 days of the transaction.

The fact that the cardholder initiates transactions that debit an account, as the term is defined in § 235.2(a), is the characteristic of deferred debit cards that distinguishes such cards from charge cards and credit cards for purposes of EFTA Section 920. In the case of charge cards and credit cards, the transactions post to lines of credit rather than accounts. Excluding cards that debit an account based on the time period within which the account is debited creates significant potential for evasion and circumvention of Section 920's provisions, as implemented by this rule. The Board notes that the EFTA and Regulation E limit the ability of an issuer to structure deferred debit cards to be more like charge cards or credit cards. The EFTA and Regulation E prohibit any person from conditioning the extension of credit to a consumer on such consumer's repayment by means of preauthorized electronic fund transfers.[71]

Two commenters requested clarification as to the types of products that qualify as "deferred debit cards," particularly as to the deferral period. Deferred debit cards may have different deferral periods specified in the cardholder agreement; however, the deferral period and when the hold is applied are not necessary to determining whether a card is a "debit card" as defined in § 235.2(f). The Board has revised proposed comment 2(f)-2 to clarify that, in the case of deferred debit cards, the issuer-cardholder agreement governs the period of time for which the issuer will hold the funds in the cardholder's account after the debit card transaction and before debiting the cardholder's account.

The Board is not at this time providing more examples of debit cards that are considered "deferred debit cards." The deferred debit cards of which the Board is aware use the framework described in comment 2(f)-2. The Board is removing the proposed examples regarding the

[71] 15 U.S.C. 1693k(1); 12 CFR 205.10(e)(1).

timing of merchants sending electronic debit transactions to acquirers as unnecessary to describe whether a debit card is a deferred debit card.

#### 4. Decoupled debit cards

Proposed comment 2(f)-3 explained that the term “debit card” included decoupled debit cards. As explained in the proposed comment, decoupled debit cards are issued by an entity other than the entity holding the cardholder’s account, and the issuer settles for the transaction with the acquirer and with the cardholder through an ACH transaction that debits the cardholder’s account.

The Board received a few comments opposed to including decoupled debit cards under the rule’s definition of “debit card,” and no comments explicitly supporting their inclusion. One commenter contended that including decoupled debit cards within the definition of “debit cards” is inconsistent with the exclusion of ACH transactions, because decoupled debit cards are used to initiate ACH debits to the account. Other commenters suggested the Board exclude decoupled debit cards issued by merchants because including them would be inconsistent with statutory intent to reduce merchant debit card expense. One commenter requested clarification as to the types of products that qualified as “decoupled debit cards.” Another commenter stated that treating the location of the asset account as irrelevant for defining “debit card,” but relevant for purposes of the small issuer exemption, is inconsistent.

The Board has considered the comments received and has determined to include decoupled debit cards that process transactions over payment card networks within the definition of “debit card” as proposed with minor clarifying revisions to the commentary. Cardholders use decoupled debit cards to initiate debits to their accounts. The Board is aware of two types of decoupled debit card transactions. The first type, described in proposed comment 2(f)-3, is

where the transaction is processed over a payment card network, and the issuer settles the transaction with the acquirer using the normal network procedures, but settles with the cardholder via an ACH transaction. In this type of transaction, the cardholder preauthorizes the ACH transaction, and the issuer initiates the ACH transaction shortly after authorizing the transaction and settling for the transaction with the acquirer through the payment card network. The second type is a transaction initiated with a card issued by the merchant, and the merchant's processor initiates an ACH debit to the cardholder's account. This second type of decoupled debit card transaction is processed solely through an ACH operator and not through a payment card network. Decoupled debit cards that are used to initiate ACH transactions at the point of sale that are not processed over a payment card network for any part of the transaction (i.e., the second type) are not debit cards under this part.

By contrast, if the card holder initiates a decoupled debit card transaction, part of which is processed over a payment card network, the decoupled debit card is a debit card for purposes of this part. Unlike decoupled debit cards that directly initiate ACH transactions, merchants cannot distinguish these decoupled debit cards from other debit card transactions that would be subject to interchange fees and network rules. Accordingly, the Board does not believe it is inconsistent to include in the definition of "debit card" decoupled debit cards that initiate transactions processed over payment card networks, while simultaneously excluding ACH transactions initiated at the point of sale.

Inclusion of decoupled debit cards that initiate transactions processed over payment card networks is consistent with the provisions in EFTA Section 920, which are intended to reduce merchant costs of accepting debit cards, even if merchants are the issuers of such cards (although the Board believes that transactions initiated with merchant-issued decoupled debit cards

generally would be processed through the ACH). Section 920 is designed to achieve cost-reduction through limitations on interchange transaction fees and prohibitions on network exclusivity and merchant routing restrictions, rather than by excluding certain cards that may be lower-cost to merchant issuers.

In addition, any inconsistency between the requirement that an issuer hold the account in order to be eligible for the small issuer exemption and the lack of relevance for purposes of defining "debit card" is statutory. Section 920(c)(9) defines the term "issuer" for general purposes of the section as the person who issues the debit card, or agent of such person. For purposes of the small issuer exemption, Section 920(a)(6) limits the term "issuer" to the entity holding the cardholder's account.

A few commenters requested that the Board provide more specific examples of decoupled debit cards. The decoupled debit cards of which the Board is aware use the framework described in comment 2(f)-3.

**5. Hybrid cards and virtual wallets**

The Board requested comment on whether additional guidance was necessary to clarify whether products with "credit-like" features are considered debit cards for purposes of this rule. The Board noted that if an issuer offers a product that allows the cardholder to choose at the time of the transaction when the cardholder's account will be debited for the transaction, any attempt to classify such a product as a credit card would be limited by the prohibition against compulsory use under the EFTA and Regulation E.

A few issuers, networks, and processors suggested that the Board exclude cards used to access or obtain payment from a credit account (i.e., cards subject to the Truth in Lending Act and Regulation Z), regardless of whether the consumer chooses to repay the credit account using

an asset account. These commenters indicated that such cards could include cards that enable the customer to pre-designate the types of transactions to be paid from a preauthorized debit to the asset account more frequently than the monthly billing cycle. Additionally, these commenters urged the Board to distinguish between credit cards that *require* repayment using preauthorized transfers and cards that *permit* repayment using preauthorized transfers, stating that the latter would not run afoul of the prohibition against compulsory use.

The Board is aware of two general categories of cards with both credit- and debit-like features (so-called "hybrid cards"). The first category includes those cards, or other payment codes or devices, used to initiate transactions that access and post to credit accounts, but that the cardholder repays through a preauthorized debit to an asset account. The second category of hybrid cards includes those cards, or other payment codes or devices, that may be used to access multiple accounts (including both credit and other accounts) (often referred to as "virtual wallets" or "mobile wallets"). Cards used to initiate transactions that access and post to credit accounts are not considered debit cards for purposes of this rule because such cards are not used to debit an account, as the term is defined in § 235.2(a). Further, cards that access credit accounts are not considered debit cards regardless of whether the cardholder pays the credit balance through preauthorized transfers from an account.

For example, a card may be used to initiate transactions that access and post to credit accounts, but the issuer enables the cardholder to preselect transactions for immediate repayment (or repayment prior to the monthly billing cycle) from the cardholder's asset account. The issuer, then, may initiate a preauthorized ACH debit to the cardholder's account in the amount of the preselected transactions. Such products, due to their classification as credit cards, may not condition the extension of credit on a consumer's repayment by means of preauthorized

electronic fund transfers.[72] An issuer may permit a cardholder to opt in to preauthorization of some or all transactions made using the credit or charge card. The Board, however, recognizes the potential for issuers to restructure existing debit cards like these hybrid cards in order to circumvent and evade this rule. Therefore, such cards will be considered debit cards for purposes of this part if the issuer conditions a cardholder's ability to preselect transactions for early repayment on the cardholder maintaining an asset account at the issuer. *See* comment 2(f)-4.ii.

The Board has added comment 2(f)-4.i to clarify that hybrid cards that permit some transactions to be posted directly to an account as defined in § 235.2(a), rather than posting first to a credit account, are considered debit cards for purposes of this part. Only those transactions that post directly to the account, however, will be considered electronic debit transactions.

The second category of hybrid cards consists of virtual or mobile wallets, which store several different virtual cards that each accesses a different account. The Board has added comment 2(f)-5 to clarify the treatment of virtual wallets under this rule. As explained in the commentary, the payment codes or devices ("virtual cards") stored in a virtual wallet may each access a different account, which may be credit accounts or accounts as defined in § 235.2(a). For example, a mobile phone may store credentials (the payment codes) for accessing four different accounts or lines of credit, which the cardholder can view on the phone's screen. At the point of sale, the cardholder selects which virtual card to use (e.g., by selecting the icon for the issuer whose card the cardholder wishes to use). If at least one virtual card within the virtual wallet may be used to debit an account under § 235.2(a), then that virtual card is a debit card for purposes of this part, notwithstanding the fact that other cards in the virtual wallet may not be

[72] 15 U.S.C. 1693k(1); 12 CFR 205.10(e)(1).

debit cards for purposes of this part. The entire virtual wallet is not considered to be the card, or other payment code or device.

### 6. Checks and similar instruments

One commenter supported the Board's exclusion of electronic images and representations of checks and similar instruments. The Board has retained the exclusion in § 235.2(f), as well as the exclusions for checks, drafts, and similar instruments.

### 7. ACH transactions

The Board received a few comments on its proposed exclusion of account numbers when used to initiate an automated clearinghouse (ACH) transaction to debit an account. One commenter thought the Board should consider account numbers used to initiate ACH transactions to be "payment codes" in order to create a level playing field between debit cards and ACH transactions. One issuer suggested that the Board broaden the ACH exclusion to include intrabank transfers initiated using an account number.

The Board has considered these comments and has determined that account numbers used to initiate ACH transactions should be excluded from the definition of "debit card." An ACH transaction is processed through an ACH operator, such as EPN or FedACH®. As explained below in relation to § 235.2(m), ACH operators are not "payment card networks" under EFTA Section 920. Therefore, an account number used to initiate an ACH transaction is not "issued or approved" for use through a payment card network and, therefore, is not a "debit card" for purposes of this rule. Payment information used to initiate intrabank transactions using an account number are not processed through either ACH operators or payment card networks and, therefore, are not debit cards under EFTA Section 920.

Even if ACH transactions were subject to this part, they already would comply with the provisions of this part. Currently, ACH operators do not establish, and receiving and originating banks do not charge, fees that are comparable to interchange fees. If a merchant were to use the ACH to clear its customers' purchase transactions, its bank chooses the ACH operator through which it will originate transactions.

The Board believes retaining an explicit exclusion from the definition of "debit card" in § 235.2(f) is unnecessary but has retained commentary to explain the exclusion (proposed comment 2(f)-7 is now designated comment 2(f)-9). This comment is useful in distinguishing decoupled debit cards (discussed above) from cardholder-initiated ACH transactions. The Board has made minor revisions to the proposed comment to clarify that an account number used to initiate an ACH transaction is not a debit card where the person initiating the ACH transaction is the same person whose account is being debited and to clarify the distinction between decoupled debit cards and cardholder-initiated ACH transactions.

**G. Section 235.2(g) – Designated automated teller machine (ATM) network**

Section 235.2(g) of the proposed rule incorporated the statutory definition (EFTA Section 920(a)(7)(C)) of "designated automated teller machine network." The proposed definition included (1) all ATMs identified in the name of the issuer; or (2) any network of ATMs identified by the issuer that provides reasonable and convenient access to the issuer's customers. The Board did not receive any comments on the proposed definition, and § 235.2(g) is adopted as proposed, with the exception of minor technical changes.

The Board also proposed comment 2(g)-1 to clarify the meaning of "reasonable and convenient access," as that term is used in § 235.2(g)(2). Under proposed comment 2(g)-1, an issuer would provide reasonable and convenient access, for example, if, for each person to whom

a card is issued, the issuer provided access to one ATM within the metropolitan statistical area (MSA) in which the last known address of the person to whom the card is issued is located or, if the address is not known, where the card was first purchased or issued.

Several consumer group commenters recommended that the Board delete proposed comment 2(g)-1. These commenters noted that certain MSAs are very large and that requiring only one ATM within the same MSA as a cardholder's last known address (or, if unknown, the card's place of purchase or issuance) could potentially be burdensome for certain cardholders when an MSA covers a sizeable area. Another industry commenter suggested that for a payroll card, an ATM available at a cardholder's workplace should be considered to provide reasonable and convenient access.

As discussed in the proposal, the proposed comment was intended to ensure that cardholders do not have to travel a substantial distance for ATM access. The Board agrees that certain MSAs are very large and, for those MSAs, providing access to one ATM may not be reasonable or convenient for many cardholders. Moreover, a network that provides ATM access that is reasonable and convenient to a cardholder's home or work address also should be considered to provide reasonable and convenient for purposes of § 235.2(g)(2). Accordingly, the Board has adopted a revised comment 2(g)-1 to provide that whether a network provides reasonable and convenient access depends on the facts and circumstances, including the distance between ATMs in the designated network and each cardholder's last known home or work address or, if a home or work address is not known, where the card was first issued.

**H. Section 235.2(h) – Electronic debit transaction**

EFTA Section 920(c)(5) defines "electronic debit transaction" as "a transaction in which a person uses a debit card." The Board proposed to define "electronic debit transaction" to mean

"the use of a debit card by a person as a form of payment in the United States" in order to incorporate the concept of "payment" already included in the statutory definition of "payment card network" and to limit application of the rule to domestic transactions.[73] As discussed above in relation to § 235.2(f), some debit cards may be used to access both accounts as defined in § 235.2(a) and lines of credit. The Board has revised the definition of "electronic debit transaction" to specify that a transaction is an electronic debit transaction only if the debit card is used to debit an account. The Board has added comment 2(h)-1 to clarify that the account debited could be, for example, the cardholder's asset account or the omnibus account that holds the funds used to settle prepaid card transactions.

A few commenters requested clarification on whether the rule would apply to Internet transactions. Section 235.2(h) does not limit the term "electronic debit transaction" to transactions initiated at brick-and-mortar store locations; the term also includes purchases made online or by telephone or mail. Accordingly, electronic debit card transactions initiated over the Internet are within the scope of this part.

One commenter suggested that the definition of "electronic debit transaction" not be limited to use as a "form of payment" because many POS networks also function as ATM networks. This commenter suggested the Board expand the definition of "electronic debit transaction" to include ATM transactions. For the reasons discussed below in relation to § 235.2(m), the Board is not revising its proposed definition of "electronic debit transaction" to include ATM transactions, but is adding comment 2(h)-2 to clarify that payment may be made in exchange for goods or services, as a charitable contribution, to satisfy an obligation, or for other purposes.

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[73] EFTA Section 920(c)(11) defines "payment card network," in part, as an entity "that a person uses in order to accept as a form of payment a brand of debit card." See discussion related to § 235.2(q) (definition of "United States") regarding the application of the rule to only domestic transactions.

As explained in the proposed commentary, the term would include use of a debit card for subsequent transactions connected with the initial transaction and would include cash withdrawal at the point of sale (provided the cardholder has also made a purchase). The Board has revised proposed comment 2(h)-1 (now designated as comment 2(h)-3) to clarify that a transaction, such as a return transaction, is an electronic debit transaction if the transaction results in a debit to the merchant's account and a credit to the cardholder's account.

The Board has also adopted its proposed comments clarifying that "electronic debit transaction" includes cash withdrawals at the point of sale (comment 2(h)-4) and that transactions using a debit card at a merchant located outside of the United States are not subject to this rule (comment 2(h)-5), with minor conforming and clarifying changes.

**I. Section 235.2(i) – General-use prepaid card**

EFTA Section 920(c)(2) defines the term "debit card" as including "a general-use prepaid card, as that term is defined in section 915(a)(2)(A)." EFTA Section 915(a)(2)(A), in turn, defines "general-use prepaid card" as those cards, or other payment codes or devices, that (1) are redeemable at multiple, unaffiliated merchants or service providers, or ATMs; (2) issued in a requested amount, whether or not such amount may be increased or reloaded; (3) purchased on a prepaid basis; and (4) honored upon presentation for goods and services.[74] The Board proposed to adopt the statutory definition with some revisions. The Board proposed to define "general-use prepaid card" to mean a card, or other payment code or device that is (1) issued on a prepaid basis in a specified amount, whether or not that amount may be increased or reloaded, in exchange for payment; and (2) redeemable upon presentation at multiple, unaffiliated merchants or service providers for goods or services, or usable at ATMs. The proposed definition included cards that a group of unaffiliated merchants agrees to accept via the rules of a payment card

[74] 15 U.S.C. § 1693l-1.

network and cards that a select group of unaffiliated merchants agrees to accept, whether issued by a program manager, financial institution, or network (referred to as "selective authorization cards"). The Board requested comment on whether selective authorization cards that do not carry a network brand should be included within the definition of "general-use prepaid card." The Board received several comments on its proposed definition, primarily concerning the exclusions from the definition of "general-use prepaid card" and selective authorization cards.

For the reasons discussed in relation to §§ 235.2(h), (l), and (m), ATM transactions are not electronic debit transactions for purposes of this rule because cash withdrawals are not "payments." Accordingly, the Board has revised the proposed definition to eliminate the unnecessary reference to prepaid cards' usability at ATMs.

**1. Credit CARD Act exclusions**

Several commenters urged the Board to incorporate the exclusions to the definition of "general-use prepaid card" in the Credit CARD Act of 2009 (CARD Act) into the definition of "general-use prepaid card." These exclusions include telephone cards; cards not marketed or labeled as gift cards; loyalty, award, or promotional gift cards; cards not marketed to the general public; cards issued only in paper form; and cards redeemable solely for admission to events or venues (or purchases of goods and services at the events or venues) at a particular location or affiliated locations.[75]

The proposed definition generally tracked the definition of "general-use prepaid card," set forth above, in EFTA Section 915(a)(2)(A). EFTA Section 915(a)(2)(D) enumerates exclusions from the term "general-use prepaid card" as defined in Section 915(a)(2)(A). In light of the explicit reference to Section 915(a)(2)(A) and the absence of a reference to Section 915(a)(2)(D), the Board has determined not to exclude the CARD Act's exclusions from the

[75] 15 U.S.C. § 1693l-1(a)(2)(D).

definition of “general-use prepaid card.”[76] Moreover, one of the enumerated exclusions in Section 920(a)(7)(A)(ii) is for cards “reloadable and not marketed or labeled as a gift card or gift certificate.” If such cards were already excluded from Section 920’s definition of “debit card” by virtue of their exclusion from the term “general-use prepaid card” in the CARD Act, Section 920(a)(7)(A)(ii)’s express exemption of such cards would be superfluous. Therefore, the Board is adopting the definition of “general-use prepaid card” as proposed (with the exception of removing the unnecessary ATM reference). The cards excluded from the CARD Act’s definition of general-use prepaid card may otherwise be excluded from the definition of “debit card” (i.e., if they are not redeemable at multiple, unaffiliated merchants) or exempt from the interchange fee standards (e.g., if they are reloadable).

**2. Selective authorization cards**

Several commenters requested that the Board exclude “selective authorization cards” from the definition of “general-use prepaid cards.” These commenters asserted that selective authorization cards more closely resemble cards that are accepted at only one merchant or affiliated merchants. Many of these commenters argued that selective authorization cards provide consumers with more shopping options than cards accepted at only one merchant, thus providing the consumer with more protection in the event of a merchant’s bankruptcy. Some commenters suggested excluding only those cards that do not carry a network brand.

The Board has considered the comments and has determined to include selective authorization cards within the definition of “general-use prepaid card.” Selective authorization cards provide benefits to the merchants or business districts wishing to promote their business, as well as to consumers wishing to mitigate their exposure in the event of a merchant’s bankruptcy. Nonetheless, one characteristic of general-use prepaid cards is that they are redeemable at

[76] The Board also notes that EFTA Section 920(c)(2) does not refer to Section 915(a)(2) more broadly.

multiple, unaffiliated merchants. Two or more merchants are affiliated if they are related either by common ownership or by common corporate control.[77] Two or more merchants are not "affiliated" within the rule's meaning of the term merely because they agree to accept the same selective authorization card. Therefore, selective authorization cards are redeemable at multiple, unaffiliated merchants. This is true regardless of whether or not the card carries the mark, logo, or brand of a network. In fact, the Board understands that transactions using some selective authorization cards that do not display a network brand logo on the card itself are processed over "brands" of payment card networks, including the major networks or smaller networks. Accordingly, there is not a basis for distinguishing network-branded selective authorization cards from non-network branded selective authorization cards.[78] Selective authorization cards, however, like other general-use prepaid cards, may not be subject to certain provisions of this part. For example, if the selective authorization card satisfies the requirements in § 235.5(c) (e.g., the card is reloadable and not marketed as a gift card), the card would not be subject to the interchange fee standards.

Proposed comment 2(i)-2 explained that "mall cards" are considered general-use prepaid cards because the cards are accepted at multiple, unaffiliated merchants. The Board is aware, however, that selective authorization cards are used outside the shopping mall environment. Selected groups of merchants within the same business district or located near a university also may accept selective authorization cards. Accordingly, the Board has expanded the scope of the proposed comment to include selective authorization cards used in all contexts.

### 3. Other comments

[77] See the discussion on the definition of "affiliate" (§ 235.2(c)), above, in this notice.
[78] For the same reason, the Board is revising its proposed comment 2(i)-2 to clarify that a general-use prepaid card is not required to display the network brand, mark, or logo in order to come within the definition of "general-use prepaid card."

The Board received one comment requesting clarification as to whether "gift cards" are included under the definition of "general-use prepaid cards." Prepaid gift cards that are redeemable at a single merchant or a group of affiliated merchants are not included within the definition of "general-use prepaid cards." By contrast, if the gift card is redeemable at multiple, unaffiliated merchants, then the gift card is a "general-use prepaid card." Gift cards that are general-use prepaid cards are not exempt from the interchange fee standards.

### J. Section 235.2(j) – Interchange transaction fee

#### 1. Summary of proposal and comments

EFTA Section 920(c)(8) defines "interchange transaction fee" as "any fee established, charged, or received by a payment card network for the purpose of compensating an issuer for its involvement in an electronic debit transaction." The Board proposed to define "interchange transaction fee" to mean "any fee established, charged, or received by a payment card network and paid by a merchant or acquirer for the purpose of compensating an issuer for its involvement in an electronic debit transaction."

#### 2. Paid by a merchant or an acquirer

The Board proposed to add the phrase "and paid by a merchant or acquirer" as a clarification of current market practice.[79] One commenter expressed concern that, by adding "and paid by a merchant or acquirer" to the statutory definition, the Board was opening up the possibility that an acquirer would contract with a middleman to pay the fee on the acquirer's behalf, which would result in circumvention or evasion of the rule. The Board does not believe that the phrase would enable such a practice. Under principles of agency (governed by state law), if an acquirer contracts with a third party to pay an interchange transaction fee on behalf of an acquirer, the fee is considered to be paid by the acquirer and would be subject to the same

[79] 75 FR 81722, 81731, and 81755 (Dec. 28, 2010).

restrictions as if the fee were in fact paid by the acquirer. Although the Board understands that, today, acquirers pay interchange transaction fees to issuers through settlement effected by a payment card network (and then pass the fee on to merchants), the Board has retained the proposed addition, noting that the interchange transaction fee can be paid either by a merchant or acquirer. The Board also has made minor revisions to comment 2(j)-2 to clarify that the fees payment card networks charge to acquirers for network services are not considered "interchange transaction fees."

**3. Established, charged, or received**

Merchant commenters voiced concerns that issuers may attempt to circumvent the interchange fee standards (applicable to those fees "established, charged, or received" by a network) by collectively setting fees and imposing those collectively set fees on acquirers, and ultimately merchants, through the networks' honor-all-cards rules. For example, the largest issuers may collectively determine to charge interchange transaction fees above the cap and effect this decision by dictating to each network the agreed upon amount. The network, then, would permit each issuer to charge that amount, and because merchants would be required to accept all the network's cards, merchants would pay the amount determined by the issuers.

Section 920(c)(8) of the EFTA defines the term "interchange transaction fee" to mean "any fee established, charged, or received by a payment card network . . . for the purpose of compensating an issuer for its involvement in an electronic debit transaction." Accordingly, interchange transaction fees are not limited to those fees *set* by payment card networks. The term also includes any fee set by an issuer, but *charged* to acquirers (and effectively merchants) by virtue of the network determining each participant's settlement position. In determining each participant's settlement position, the network "charges" the fee, although the fee ultimately is

received by the issuer.  An issuer, however, would be permitted to enter into arrangements with individual merchants or groups of merchants to charge fees, provided that any such fee is not established, charged, or received by a payment card network.  The Board has added paragraph 2(j)-3 to the commentary to explain that fees set by an issuer, but charged by a payment card network are considered interchange transaction fees for purposes of this part.  The Board plans to monitor whether collective fee setting is occurring and whether it is necessary to address collective fee setting or similar practices through the Board's anti-circumvention and evasion authority.

One commenter urged the Board to adopt a definition of "interchange transaction fee" that covers both the fee flowing from merchant to network and the fee flowing from network to issuer so as to require that the two amounts be equal.  This commenter was concerned that, otherwise, networks with widespread acceptance would be able to engage in price discrimination.  Networks may charge lower fees to acquirers than they pass through to the issuers in order to compete for transaction volume in certain market segments, while charging higher fees to acquirers than they are passing through to the issuers in other market segments, although today these amounts are the same.  The Board, however, has determined not to revise its proposed definition of "interchange transaction fee" to cover both the fee flowing from merchant to network and the fee flowing from network to issuer so as to require that two amounts be equal.  By statute, an interchange transaction fee is a fee established, charged, or received by a payment card network for the purpose of compensating an issuer and Section 920(a) limits the amount that the issuer may receive.  By contrast, Section 920(a) does not prohibit networks from charging other fees to merchants or acquirers that are not passed to the issuer and does not require that the network pass through to the issuer the same amount charged

to the acquirer. The Board plans to monitor whether networks are charging other fees that are being passed to the issuer and determine whether it is necessary to address network fees through the Board's anti-circumvention and evasion authority.

## K. Section 235.2(k) – Issuer

### 1. Summary of proposal and comments

EFTA Section 920(c)(9) defines the term "issuer" to mean "any person who issues a debit card, or credit card, or the agent of such person with respect to such card." The Board proposed to define "issuer" to mean "any person that issues a debit card." Proposed comments 2(k)-2 through 2(k)-5 provided examples of which entity was considered the issuer in a variety of debit card arrangements. As described in the proposed commentary, the issuer in four-party systems is the bank holding the cardholder's account, and the issuer in three-party systems is the entity acting as issuer and system operator (and typically acquirer as well). The issuer in debit card BIN-sponsor arrangements is the bank holding the cardholder's account, and the issuer in prepaid card BIN-sponsorship arrangements is the BIN sponsor holding the omnibus account.[80] Finally, the issuer of a decoupled debit card is the entity providing the card to the cardholder, not the bank holding the cardholder's account.

The Board received several comments on its proposed definition of "issuer," one of which generally supported the proposed definition. Many of the comments received addressed the proposed removal of the phrase "or agent of such person" from the statutory definition. Two commenters suggested that Board exclude third-party agents as proposed, because unlike credit

[80] As explained in the proposed commentary, payment card networks assign Bank Identification Numbers ("BINs") to member institutions for purposes of issuing cards, authorization, clearance, settlement, and other processes. In exchange for a fee or other financial considerations, some member institutions permit other entities to issue debit cards using the member-institution's BIN. The entity permitting the use of its BIN is referred to as the "BIN sponsor" and the entity that uses the BIN to issue cards is often referred to as the "affiliate member." BIN-sponsor arrangements are done for debit cards (including prepaid cards).

cards, debit card issuers typically do not use third-party agents. One commenter argued that the agent of an issuer should only be considered the issuer when the agent has a level of control such that the role of the issuer is subordinated to that of its agent. A few other commenters requested that the Board clarify the effect on the interchange fee restrictions of eliminating "or agent of the issuer" and further study the issue.

The Board also received a few comments requesting clarification on whether an issuer that outsources processing functions is responsible for complying with the requirements, or whether the third-party processor must comply with the requirements. One commenter specifically expressed concern about a covered issuer being able to contract with a small issuer for issuance of the card and having the small issuer receive and pass back the higher interchange fees. The Board also received a comment requesting clarification on which party is considered the issuer under a variety of mobile payments arrangements.

**2. Analysis and final rule**

The Board has considered the comments and has determined to revise its definition of "issuer" to clarify the meaning of "issue." In general, the proposed commentary explained which entity is the issuer in terms of which entity has the underlying contractual agreement with the cardholder. Although the underlying contractual agreement with the cardholder is one of the defining characteristic of issuing debit cards, the Board believes that it is clearer and more precise to explain the underlying agreement in terms of authorizing the use of the card to perform electronic debit transactions. The entity that authorizes use of the card may also be the entity that arranges for the cardholder to obtain the card. The revisions to the commentary describe this component of issuing in terms of "authorizing" the cardholder to use the card to perform electronic debit transactions, rather than the more general term "provide" as proposed.

Therefore, the identity of the issuer is not determined by which entity performs issuer processing, but rather by which entity authorized the cardholder to use the card to perform electronic debit transactions.

The Board has revised comment 2(k)-1 to provide more guidance on which entity is the issuer for purposes of this part. Comment 2(k)-1 explains that a person issues a debit card by authorizing a cardholder to use the debit card to perform electronic debit transactions. That person may provide the card directly or indirectly to the cardholder. For example, a person may use a third-party processor to distribute a plastic card to the cardholder, or may use a phone network or manufacturer to distribute a chip or other device as part of a phone. The entity that distributes the card, or other payment code or device, is not the issuer with respect to the card unless that entity also is the one authorizing the cardholder to use the card, or other payment code or device, to perform electronic debit transactions.

Proposed comments 2(k)-2 and 2(k)-3 discussed the identity of the issuer in four-party and three-party systems, respectively. In light of the changes discussed below in relation to § 235.2(m), which clarify that three-party systems are not payment card networks for purposes of this rule, the Board has deleted the proposed commentary language that discusses three-party systems and is making other clarifying changes for consistency in other commentary provisions. *See* comment 2(k)-2.

Proposed comment 2(k)-4 described which entity was the issuer under two different types of BIN-sponsor arrangements: the sponsored debit card model and the prepaid card model. Proposed comment 2(k)-4.i stated that the issuer in a sponsored debit card arrangement was the community bank or credit union providing debit cards to its account holders using a BIN of another institution (the "BIN sponsor"). The Board has revised the proposed comment to explain

that the community bank or credit union is an issuer if it authorizes its account holders to use the debit cards to access funds through electronic debit transactions. The community bank or credit union may provide debit cards directly or indirectly (e.g., through its BIN sponsor) to cardholders. The BIN sponsor is not considered the issuer for purposes of this part because the BIN sponsor does not enter into an agreement with the cardholder authorizing the cardholder to use the card to perform electronic debit transactions to access funds. The Board also has revised the comment to refer consistently to the "bank or credit union" throughout the comment. *See* comment 2(k)-3.i.

Proposed comment 2(k)-4.ii stated that the issuer in the second type of BIN-sponsor model—the prepaid card model—is the BIN sponsor holding the funds underlying the prepaid cards. The Board has revised the proposed comment to clarify that, under these arrangements, the BIN sponsor typically uses a program manager to distribute cards to cardholders, and the BIN sponsor typically holds the funds in an omnibus or pooled account. Under these arrangements, either the BIN sponsor or the program manager may track the amount of underlying funds on each card. The revised comment explains that the BIN sponsor is the issuer because it is the entity authorizing the cardholder to use the card to perform electronic debit transactions to access the funds held by the BIN sponsor and also has the contractual relationship with the cardholder. *See* comment 2(k)-3.ii. The Board also has revised this comment, as well as other comments, to refer to "member institutions" rather than "member-financial institutions" for consistency throughout the commentary.

Proposed comment 2(k)-5 explained that the issuer with respect to decoupled debit card arrangements is the entity that provides the debit card to the cardholder and initiates a preauthorized ACH debit to the cardholder's account at a separate institution. The Board has

revised proposed comment 2(k)-5 (now designated as 2(k)-4) to clarify that the bank or other entity holding the cardholder's funds is not the entity authorizing the cardholder to use the decoupled debit card to perform electronic debit transactions. Rather, the bank or other entity holding the cardholder's funds has authorized access to the funds through ACH debits in general, but not specifically through the decoupled debit card. The Board has deleted the statement in proposed comment 2(k)-5 that the account-holding institution does not have a relationship with the cardholder with respect to the card because the statement is unnecessary to explain the identity of the issuer of the card.

The Board has not provided examples in the commentary that are specific to mobile devices and mobile payments. A mobile device, such as a chip in or on a telephone or a software application on the telephone, is one type of payment code or device that may be used to access underlying funds. If the cardholder's bank authorizes the cardholder to use a device connected with the phone and arranges for the cardholder to obtain the device through the phone network or manufacturer, or other party, the cardholder's bank is the issuer with respect to the mobile device. By contrast, if the mobile device is more like a decoupled debit card where the mobile device is used to initiate debits to an account, but those debits settle through a preauthorized ACH transaction, the cardholder's bank is not the issuer. Rather, the entity that provided the mobile device to the cardholder to ultimately access the underlying funds is the issuer. Depending on the debit card arrangement, this entity may be either the phone network, phone manufacturer, or other entity.

As explained in the proposal, as a matter of law, agents are held to the same restrictions with respect to the agency relationships as their principals. In other words, a third-party processor cannot act on behalf of an issuer and receive higher interchange fees than are

permissible for the issuer to receive under this rule. For example, if an issuer uses a third-party processor to authorize, clear, or settle transactions on its behalf, the third-party processor may not receive interchange fees in excess of the issuer's permissible amount. Therefore, the Board does not believe that removing the clause "or agent of such person" will have a substantive effect on either the interchange fee restrictions or the network exclusivity and routing provisions. In assessing compliance, any interchange transaction fee received by the agent of the issuer will be deemed to be an interchange transaction fee received by the issuer.

**L. Section 235.2(l) – Merchant**

EFTA Section 920 does not define the term "merchant."[81] The Board proposed to define "merchant" to mean "any person that accepts debit cards as payment for goods or services." The Board did not receive comments specifically on the proposed definition; however, a few commenters suggested that ATM operators be included in the definition of "merchant." As discussed below in relation to § 235.2(m), ATM operators do not accept payment in exchange for goods or services. Rather, ATM operators facilitate cardholders' access to their own funds. The Board has revised § 235.2(l) so as to not limit the purposes for which a person accepts payment to being in exchange for goods or services. *See* § 235.2(h) and comment 2(h)-2. This expansion does not include ATM operators within the definition of "merchant."

**M. Section 235.2(m) – Payment card network**

EFTA Section 920(c)(11) defines "payment card network" as "an entity that directly, or through licensed members, processors or agents, provides the proprietary services, infrastructure, and software that route information and data to conduct debit card or credit card transaction authorization, clearance, and settlement, and that a person uses in order to accept as a form of

[81] Section 920(c)(11)'s definition of "payment card network" refers to "an entity . . . that a person uses in order to accept as a form of payment a brand of debit card."

payment a brand of debit card, credit card or other device that may be used to carry out debit or credit transactions." The Board proposed a modified version of the statutory definition as defining the term "payment card network" to mean an entity that (1) directly or indirectly provides the services, infrastructure, and software for the authorization, clearance, and settlement of electronic debit transactions and (2) establishes the standards, rules, or procedures that govern the rights and obligations of issuers and acquirers involved in processing electronic debit transactions through the network. Proposed commentary 2(m)-1 further explained the proposed criteria that only those entities that establish rules governing issuers and acquirers be considered payment card networks. The Board received several comments on its proposed definition of "payment card network." A few commenters generally supported the Board's proposed definition.

A few commenters supported the Board's proposed exclusion of issuers, acquirers, and processors from the definition of "payment card network." These commenters argued that including these entities in the definition was beyond the intent of EFTA Section 920 and would have unintended consequences. By contrast, other commenters argued that the statutory definition of "payment card network" was broad enough to include processors and gateways, among other entities. One commenter suggested that the Board consider third-party intermediaries to be "payment card networks" if a network contracts with them to perform functions traditionally performed by a network.

**1. Standards, rules, or procedures governing issuers and acquirers**

One commenter expressed concern that adding the "standards, rules, or procedures" criteria would reduce the Board's flexibility to cover emerging payment systems under the rule. A few commenters also suggested that the Board impose substantive requirements on the rules

that entities establish in order to be considered "payment card networks" for purposes of this rule. In particular, these commenters suggested the Board require the "standards, rules, or procedures" to include consumer chargeback rights.

The Board has considered the comments received and has determined to revise the final rule to eliminate the "standards, rules, or procedures" criteria. This recognizes that processors and gateways may be "payment card networks" with respect to electronic debit transactions depending on their role (discussed below in connection with this defined term). To be considered a payment card network for purposes of this rule an entity must do more in relation to a transaction than provide proprietary services, infrastructure, and software to route the transaction information to conduct authorization, clearance, and settlement. The Board continues to believe that an entity that acts solely as an issuer, acquirer, or processor with respect to an electronic debit transaction is not covered by the definition of "payment card network," because such entities do not route information and data between an acquirer and an issuer with respect to the transaction. In order to make this clear, the final rule provides that an entity is considered a payment card network only if the entity routes electronic debit transaction information and data between an acquirer and issuer.[82]

Processors and gateways may take on different roles depending on the transaction. For example, for a given transaction, an entity may act as processor to both the acquirer and the issuer. The acquirer and issuer may wish to bypass the network for such a transaction and may themselves establish standards, rules, or procedures for so doing, while relying on the processor or gateway to process the electronic debit transaction and charge and pay fees between the acquirer and issuer. In that case, the Board believes the processor is acting as a payment card

[82] The Board is not adopting the guidelines, rules, or procedures requirement and, therefore, it is not necessary to address the comments regarding substantive requirements of such standards, rules, or procedures.

network and should be considered a "payment card network" with respect to the transaction for purposes of the rule. Accordingly, the Board has revised the commentary to the definition of "payment card network" to explain that an entity that acts as processor between issuers and merchants without routing the transaction through an intervening payment card network would be considered a payment card network with respect to those transactions. *See* comment 2(m)-3.

Some emerging payment systems may resemble payment card networks, while others may resemble acquirers or acquirer processors. Like existing entities, if the emerging payment system routes transaction information and data between acquirers and issuers, and not to an intervening payment card network, the system will be considered a payment card network for purposes of those transactions, provided the entity satisfies the other criteria in § 235.2(m). If a payment card network contracts with another entity to perform network-like functions on behalf of the payment card network, the other entity is considered the agent of the payment card network.

**2. Proprietary services and brands of payment cards**

The proposal did not include the statutory text that a payment card network provides "proprietary" services, infrastructure, and software provided for authorization, clearance, and settlement and that those services enable a person to accept "a brand of debit card." The Board received one comment suggesting the Board retain the statutory concept that a payment card network provides "proprietary" services that a person uses to accept "a brand of debit card." In light of the other transaction types that resemble electronic debit transactions (e.g., ACH transactions), specifically incorporating the concept of payment card networks providing proprietary services that a person uses to accept "a brand of payment card" (although not necessarily the brand of the entity providing the services, infrastructure, and software) is a

meaningful way of distinguishing between the networks traditionally thought of as "payment card networks" and other entities that provide services, infrastructure, and software that provide debits and credits to accounts on their own books. Accordingly, the final rule adopts the more complete statutory language rather than the truncated proposed language.

The proposed definition of "debit card" excluded account numbers used to initiate an ACH transaction. As noted above in the discussion of § 235.2(f), retaining an explicit exclusion within the definition of "debit card" is no longer necessary because an account number used to initiate ACH transactions is not a "brand" of debit card or other device, as the account number is not associated with a "brand" of ACH network. An ACH transaction is processed through an ACH operator, either EPN or FedACH®. Merchants use account numbers or other information to initiate a particular type of transaction (i.e., ACH), but these account numbers are not "brands" of cards, or other payment codes or devices. Therefore, ACH operators should not be considered "payment card networks" for purposes of the rule. The Board has added comment 2(m)-4 that explains that ACH operators are not considered "payment card networks" under this part.

**3. Credit cards**

The Board proposed to remove the reference to "credit cards" from the definition of "payment card network" as unnecessary in light of the fact that the Board's rule would apply only to debit card-related interchange fees and routing restrictions. One commenter suggested the Board retain the references to "credit card" because removing the reference would have an impact on the application of EFTA Sections 920(b)(2) and (b)(3), as well as for the application to hybrid credit-debit cards. Removing the reference to "credit card" in the definition of payment card network will not affect the application of Section 920(b)(2) (discounts at the point of sale) or Section 920(b)(3) (transaction minimums and maximums). Section 920(b)(2) is

not dependent on any Board rulemaking, and Section 920(b)(3) authorizes the Board to increase the level of the minimum transaction value merchants may impose. The Board, however, did not request comment on an increase and is not at this time adopting provisions in this part pursuant to Section 920(b)(3). If the Board determines to increase the minimum dollar value in Section 920(b)(3), the Board at that time will consider whether revisions to the definition of payment card network are necessary for that purpose. Therefore, the Board has not retained the statutory reference to "credit card" in the definition of payment card network.

### 4. Routing transaction information and three-party systems

The proposed definition of payment card network did not incorporate the statutory concept of providing services, infrastructure, and software "to route information and data to conduct" debit card transactions. Rather, the Board proposed to shorten the definition to include the provision of services, infrastructure, and software "for" authorization, clearance, and settlement. The Board did not receive comments specifically on this proposed change from the definition in EFTA Section 920(c)(11). The Board did, however, receive comments on the inclusion of three-party systems within the scope of the rule.

#### a. Summary of proposal

The Board proposed that its rule cover three-party systems as well as four-party systems. The Board noted, however, the practical difficulties in applying the interchange fee standards to three-party systems, which charge only a merchant discount and no explicit interchange fee. Specifically, a three-party system could apportion its entire merchant discount to its role as network or acquirer, rendering the interchange fee zero, in effect, and EFTA Section 920 does not restrict fees an acquirer charges a merchant. Therefore, the Board requested comment on the

appropriate application of the interchange fee standards to electronic debit transactions processed over three-party systems.

In addition, the Board requested comment on how the network exclusivity and routing provisions should be applied to three-party systems, including alternatives that could minimize the compliance burden on such systems. If those provisions were applied to a three-party system, debit cards issued by the network must be capable of routing transactions through at least one unaffiliated payment card network, in addition to the network issuing the card, and the network may not inhibit a merchant's ability to route a transaction to any other unaffiliated network(s) enabled on a debit card. The Board recognized that the nature of a three-party system could be significantly altered by any requirement to add one or more unaffiliated payment card networks capable of carrying electronic debit transactions involving the network's cards.

**b. Summary of comments**

The Board received comments regarding the application of both the interchange fee standards and the network exclusivity and routing provisions to three-party systems. In general, almost all of these comments recognized that three-party systems do not charge explicit interchange fees, but many of the commenters (particularly issuers and four-party systems) were concerned that exempting three-party systems from the interchange fee standards would create an uneven playing field. Some of these commenters were concerned that excluding three-party systems would prompt current four-party systems to vertically integrate and become three-party systems, which they believed could be considered circumvention or evasion of the rule. Other commenters recommended that, if covering three-party systems was not feasible, the Board should at least examine whether excluding three-party systems places four-party systems at a competitive disadvantage.

One commenter suggested the Board require three-party systems to provide the Board with an allocation of the merchant discount that explicitly identifies an "interchange fee." Other commenters that favored applying the interchange fee standards to three-party systems also suggested that the Board prohibit a three-party system from allocating fees away from the issuer side and to the acquirer side. Other commenters suggested that the Board deem three-party systems to be in compliance if the merchant discount charged by three-party systems was similar to merchant discounts charged in four-party systems.

Other issuers and three-party systems supported excluding three-party systems from the interchange fee standards, noting that such systems currently do not establish or charge a fee similar in concept to an "interchange fee." These commenters also stated that the Board had no authority under EFTA Section 920 to regulate merchant discounts. Moreover, some of these commenters claimed that developing a framework and method for calculating an implicit merchant discount would be unworkable and arbitrary. Commenters (including some representing merchants) contended that three-party systems do not raise the same centralized price-setting concerns as four-party systems because merchants negotiate directly with the three-party system setting the merchant discount.

With respect to the network exclusivity and routing provisions, the Board received comments from issuers and networks, some of which supported applying the provisions to three-party systems, whereas others did not. Almost all of these commenters recognized the circuitous routing that would result if three-party systems were subject to the network exclusivity and routing provisions (because all transactions on cards issued for three-party systems ultimately would need to be routed back to the system operator/issuer for authorization, clearance, and settlement), but, similar to the application of the interchange fee standards, commenters believed

that exempting three-party systems would create an uneven playing field.[83] By contrast, several commenters supported excluding three-party systems from the network exclusivity and routing provisions' coverage because, by definition, three-party systems operate on a single "network." Therefore, the commenters contended, application of the rules to three-party systems would have a detrimental effect on the three-party business model. One three-party system stated that the Board should invoke EFTA Section 904(c) to exempt three-party systems.[84] This commenter asserted that three-party systems do not "restrict" the networks over which an electronic debit transaction may be processed "by contract, requirement, condition, penalty," or other similar method.[85] Rather, according to the commenter, the closed-loop characteristic is intrinsic to three-party systems. The commenter concluded that the network exclusivity and routing provisions were ambiguous as applied to three-party systems.

The Board also received a few comments on its characterization of three-party systems in its proposed rule. One commenter asserted that the Board's characterization ignores the fact that some "three-party systems" provide network and issuing functions but not acquiring functions. This commenter suggested that the Board should characterize three-party systems as those where the network is also the issuer, regardless of whether the entity acquires transactions, because the rules are primarily focused on network-issuer relationship. Similarly, another commenter stated that "three-party systems" may have the ability to route transactions outside the system, and that, in such cases, the network exclusivity and routing provisions should apply to the "three-party

[83] If a three-party system were to enable its cards for transaction processing over a second network, the authorization, clearance, and settlement would be done by the three-party system. Therefore, the transaction would go outside the system only to be sent back to the system for authorization, clearance, and settlement.
[84] See discussion in connection with § 235.5 regarding the Board's authority under EFTA Section 904(c) as applied to this rulemaking.
[85] This commenter argued that the Board should interpret "or otherwise" to mean by devices or mechanisms similar to those specifically listed.

system." A few commenters requested that the Board provide more examples of three-party systems.

### c. Analysis and final rule

In a three-party payment system, the same entity serves as the issuer and system operator, and typically the acquirer.[86] For debit card transactions in three-party systems, the merchant sends the authorization request, as well as any other information necessary to settle a transaction, typically to one entity. By contrast to four-party systems, the system operator that receives the transaction information and data does not direct the information and data to another party. Rather, that entity uses the transaction information and data to approve or decline the transaction, as well as to settle the transaction with both the merchant and the cardholder. If the three-party system involves separate acquirers, the issuer/system operator will remit funds to the acquirer through whatever settlement method the parties agreed to.

A merchant must send the transaction information and data to the issuer (or issuer's processor) for authorization, as well as clearance and settlement. In a four-party system, the information and data are sent to a network that, in turn, sends the information and data to an issuer (or the issuer's processor). Network entities in four-party systems provide services, infrastructure, and software that receive transaction information and data from the merchant side of the transaction and send the information and data to the designated issuer. By contrast, in a three-party system, a single entity operates the system and holds the cardholder's account. Typically that entity holds the merchant's account as well, but may permit other entities to acquire transactions. Once the system operator receives the transaction information and data, the operator does not send the information and data on to another point. Rather, all authorization

[86] In addition, under a three-party system, outside processors may provide some processing services to the merchant, but are not authorized to acquire transactions. The other parties to a three-party system are the cardholder and the merchant.

and settlement decisions and actions occur within that entity. Therefore, three-party systems provide services for merchants to send and receive transaction information and data, but not to "route" transaction information and data. Merchants are able to protect themselves from excessive fees in three-party systems by negotiating directly with the issuer-system operator, unlike in the case of four-party systems, where a network intervenes between the issuer and merchant.

EFTA Section 920(c)(11) defines "payment card network" as "an entity that directly, or through licensed members, processors, or agents, provides the proprietary services, infrastructure, and software, that route information and data to conduct debit card or credit card transaction authorization, clearance, and settlement . . . ."[87] The Board's proposal did not include the statutory text that a payment card network provide the services, infrastructure, and software that "route information and data to conduct" electronic debit transaction authorization, clearance, and settlement. The statute does not define the term "route." The term "route" is commonly defined as "to send by a certain [or selected] route" or "to divert in a specified direction."[88] In other words, routing suggests involvement other than merely receiving and using information and data; specifically, routing suggests sending the information and data to another point or destination.[89] Connecting numerous different points, in this case numerous merchants and issuers, is a fundamental element of any network. The final rule modifies the proposal to incorporate this statutory reference to routing in the definition of payment card network.

Accordingly, three-party systems are not "payment card networks" for purposes of the rule because they do not "provide[] the proprietary services, infrastructure, and software that

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[87] EFTA Section 920(c)(11).

[88] *See, e.g.*, *Webster's New World Dictionary and Thesaurus* at 558 (2d ed. 2002); *Merriam Webster's Collegiate Dictionary* at 1021 (10th ed. 1993).

[89] See discussion below in connection with § 235.2(p).

route information and data to an issuer from an acquirer to conduct the authorization, clearance, and settlement of electronic debit transactions."[90] Because three-party systems are not payment card networks, they are not subject to the interchange fee standards (as there is no payment card network establishing, charging, or receiving a fee) or to the network exclusivity or routing provisions (as there is no payment card network to which an issuer could restrict the processing of transactions).[91]

The Board has made conforming changes to its proposed commentary. First, the third sentence in proposed comment 2(m)-1 that stated that three-party systems are considered payment card networks has been removed. Second, commentary to explain the routing component of the definition and the definition's application to three-party systems has been added. Comment 2(m)-1 has been revised to state that an entity that authorizes and settles an electronic debit transaction without routing information to another entity generally is not considered a payment card network. New comment 2(m)-2 has been added to explain that three-party systems are not "payment card networks" for purposes of the rule. Comment 2(m)-2 clarifies that "routing" transaction information and data involves sending such information and data to an entity other than the entity that initially receives the information and data, and does not include merely receiving information and data. *See* comment 2(p).

### 5. ATM transactions and networks

#### a. Summary of proposal and comments

The Board requested comment on whether ATM transactions and networks should be included within the scope of the rule. The Board also requested comment on how to implement

[90] Transactions through three-party systems are similar to other "on-us" transactions that can be authorized, cleared, and settled using a book-entry rather than sending information to another point.
[91] Because three-party systems are not payment card networks for purposes of this rule, it is not necessary to address the comments regarding calculating an implicit interchange fee for three-party systems.

the network exclusivity provision if ATM transactions and networks are included within the scope of the rule. The Board noted that the interchange fee standards would not apply to ATM interchange fees, which currently flow from the issuer to the ATM operator, and therefore do not meet the statutory definition of "interchange transaction fee."

The network-exclusivity prohibition and routing provisions, however, would directly affect the operations of ATM networks if these provisions were applied to such networks. Issuers would be required to offer ATM cards that can be accepted on at least two unaffiliated networks, and the ATM operator would have the ability to choose the network through which transactions would be routed. The proposal explained that covering ATM networks under the rule may result in very different economic incentives than coverage of point-of-sale debit card networks because the party receiving the interchange fee would be able to control the transaction routing.

The Board received comments in support of excluding ATM transactions from the scope of the rule and in support of including ATM transactions within the scope of the rule. Those commenters that opposed including ATM transactions within the scope of the rule argued that ATM withdrawals are not a payment for goods or services. Rather, these commenters argued that the customer is accessing his or her own funds. By contrast, commenters in support of including ATM transactions within the scope of the rule asserted that ATM operators are "merchants" selling convenient access to cash and that ATM transactions debit accounts.

Both the commenters in support of and opposed to including ATM transactions supported the Board's interpretation that interchange fees for ATM transactions would be excluded from the rule's coverage (even if ATM transactions were otherwise included) because issuers do not receive or charge interchange fees for ATM transactions. A few commenters believed ATM

transactions to be outside the scope of EFTA Section 920 because merchants are not charged for ATM transactions. Furthermore, commenters stated that, unlike for debit card transactions, ATM networks currently have incentives to lower interchange fees in the ATM industry in order to compete among issuers, who are paying interchange fees. Commenters also contended that applying the interchange fee standards to ATM interchange fees could render ATM terminals cost-prohibitive, emphasizing the extent to which ATM operators rely on interchange to cover operational costs. Moreover, one commenter asserted that the Board did not have sufficient information about ATM interchange fees and costs to set standards for such interchange fees.

The commenters supporting application of the network exclusivity and routing provisions to ATM transactions generally were ATM operators or acquirers. These commenters argued that including ATM transactions within the scope of the network exclusivity and routing provisions would increase competition in the ATM industry and enable ATM operators to route transactions to the network with the lowest network fees. More generally, these commenters claimed that eliminating network exclusivity and routing practices in the ATM industry would benefit consumers through reduced ATM convenience fees, help small issuers relying on nonbank ATMs, and ensure that cash remains a viable alternative to debit cards. One commenter suggested that issuers be able to satisfy any requirement for multiple networks by enabling debit networks that also function as ATM networks.

By contrast, the commenters that opposed applying the network exclusivity and routing provisions to ATM transactions were generally issuers and payment card networks. These commenters argued that including ATM transactions under the rule would enable the party receiving the interchange fee to direct the routing of the transaction, a practice prohibited by the network routing provisions in the point-of-sale environment. Commenters also expressed

concern that, if the network exclusivity provision applied to ATM cards and networks, the establishment of settlement arrangements with multiple networks would create a large burden on issuers, which could result in higher consumer fees. One issuer that was opposed to applying the network exclusivity provisions to ATM cards argued that doing so was unnecessary because many issuers currently have at least two unaffiliated network options on their cards.[92]

**b. Analysis and final rule**

The Board has considered the comments and has determined that ATM transactions are not subject to either the interchange fee standards or the network exclusivity and routing provisions. The statute does not expressly include ATM transactions within its scope, but ATM cards, similar to debit cards, are used to debit accounts, as the term is defined in § 235.2(a). The terms "debit cards" and "electronic debit transaction" are both connected to EFTA Section 920(c)(11)'s definition of "payment card network," which is limited to those networks a person uses to accept a debit card "as a form of payment." "Payment" generally is thought of as exchanging money for goods or services or other purposes (e.g., satisfying an obligation or a making a charitable contribution), rather than changing the form of a person's money (e.g., from a balance in an account to cash).[93] In an ATM transaction, a person is using the card to access his or her money. Similarly, a cardholder may use an ATM to transfer money from one account to another. Withdrawing money from one's own account is not a payment to an ATM operator in exchange for goods or services, to satisfy an obligation, or for other purposes.[94] Therefore, a network providing only ATM services is not a payment card network. Consequently, a card is

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[92] The Board also received comments requesting that the Board permit ATM operators to impose differential surcharges based on the network the transaction is routed over. This suggestion is outside the scope of the rule.
[93] *See Black's Law Dictionary* at 950 (abridged 8th Ed.); *Merriam Webster's Collegiate Dictionary* at 963 (10th ed. 1993).
[94] To the extent the cardholder is paying for the service of being able to access his or her money, the amount paid for that service is the convenience fee charged by the ATM operator.

not a “debit card” by virtue of its being issued or approved for use through an ATM network, which, in turn, means that the ATM transaction is not an “electronic debit transaction” as those terms are defined in EFTA Section 920. Therefore, ATM networks and transactions are not within the scope of either the interchange fee standards or the network exclusivity and routing provisions. The Board has added comment 2(m)-5, which clarifies that ATM networks are not payment card networks for purposes of this part.

One commenter suggested the Board address the treatment of ATM transactions within the rule text. As discussed above in connection with § 235.2(h), the Board has not explicitly excluded “transactions initiated at an automated teller machine (ATM), including cash withdrawals and balance transfers initiated at an ATM” in the definition of “electronic debit transaction.”

Even if ATM transactions were included within the scope of the rule, interchange fees received on ATM transactions are not “interchange transaction fees” as defined in EFTA Section 920(c)(8) because ATM interchange fees do not compensate an issuer. Additionally, applying the network exclusivity and routing provisions to ATM transactions would provide incentives to the party directing the routing to select the network that maximizes interchange fees, although also one that minimizes network fees.

**6. Non-traditional and emerging payments systems**

**a. Summary of proposal and comments**

The Board requested comment on whether non-traditional or emerging payment systems should be covered by the definition of “payment card network.” In its request for comment, the Board provided examples of non-traditional or emerging payment systems, which included systems in which a consumer uses a mobile phone to purchase goods or services with the

payment amount billed to the mobile phone account or debited directly from the consumer's bank account, or systems such as PayPal, in which a consumer may use a third-party payment intermediary and use funds that may be held either by the intermediary or in the consumer's account held at a different financial institution.[95] The Board stated that these non-traditional and emerging payment systems arguably satisfied the proposed criteria for payment card networks, and requested comment on how it would distinguish these payment systems from traditional debit card payment systems in the event commenters believed such non-traditional and emerging payment systems should not be covered.

The Board received numerous comments on whether emerging payment networks should be considered "payment card networks" under the rule, and as groups, both issuers and networks were divided as to their views. The Board received comments from issuers, networks, and merchants that supported including emerging payment systems and more generally, any entity that satisfied the criteria of a "payment card network" under the proposed definition. These commenters argued that excluding emerging payments technologies would create an unfair benefit to the emerging payment systems.[96] In addition, some commenters believed that emerging payment systems should be built for multiple routing options and that the Board should encourage the interoperability of systems and technologies.

The Board also received comments from networks, issuers, and emerging payments technology providers that supported excluding emerging payment systems from the definition of "payment card network." These commenters argued that including emerging payments technologies would hinder development and innovation of new technologies because networks, issuers, and other processors would be less likely to innovate if they must share new technology

[95] A few commenters stated that PayPal should no longer be considered an "emerging" payment system due to its broad adoption and that PayPal operates like a three-party system.
[96] One of these commenters stated that asymmetric regulation would distort innovation and market evolution.

with at least one other network under the network exclusivity provisions. Commenters asserted that inclusion often would not be practical because alternative form factors initially may not be capable of being processed on more than one unaffiliated network. Moreover, one commenter asserted that innovation could be hindered if a competing payment card network blocked adoption of technology by refusing to use it, and thereby prevented the technology from being processed over more than one network. One commenter further contended that such a barrier would exacerbate the already significant barriers to entry in the payments industry. A few of these commenters asserted that non-traditional payment systems offer a competitive alternative to the traditional payment card networks. One commenter argued that the emerging payments technologies should be excluded because merchant adoption of technology is voluntary. Another commenter suggested that the Board initially exclude emerging payment systems, but continue to monitor whether such systems continue to be "emerging."

A few commenters (typically merchants and emerging payment card networks) suggested that emerging payment systems be subject to the rule, but not while the emerging payment system is deployed on a limited, pilot basis. Similarly, one commenter suggested that emerging payment technologies be included, but that an issuer be able to rebut the presumption of inclusion by demonstrating that processing over two networks is not technologically possible or cannot be deployed in a cost-effective manner.

**b. Non-traditional payment systems**

Non-traditional and emerging payment technologies generally fall into three categories: those that facilitate payments but do not come within the scope of the definition of "payment card network," emerging devices or authentication methods used to access existing payment card networks, and new payment card networks. In general, non-traditional payment systems should

not be excluded from coverage merely because the payment systems are "non-traditional." Excluding these systems solely because they are "non-traditional" would not result in a rule that is flexible to accommodate future developments in the industry. Rather, the application of the rule to non-traditional payment systems is determined by whether the characteristics of the entity with respect to transactions make the entity a payment card network, issuer, or acquirer as those terms are defined in the rule.

Some non-traditional payment systems perform functions similar to traditional payment card networks, but are structured such that these entities are not "payment card networks" as the term is defined in the rule. For example, an entity may provide services that enable merchants to accept payments from customers by permitting customers to prefund accounts with the entity. Similar to prepaid cards, such accounts could be prefunded with ACH transfers or by a debit or credit card transaction that debits the customer's account at an issuer. Later, a customer may use his or her account information to initiate a debit to her account with the entity in order to pay the merchant for goods or services. If the customer and merchant both hold accounts with the entity, similar to three-party systems, the entity does not route the transaction information and data. Rather, the entity uses the information to make a debit entry to the customer's account and a credit entry to the merchant's account. Therefore, an entity is not a "payment card network" for purposes of this rule when the entity does not send the transaction information and data to another point and instead merely makes book-keeping entries.

Like other three-party systems, a non-traditional payments system that is not a "payment card network" with respect to some transactions may be a payment card network, issuer, or acquirer with respect to other transactions. For example, in addition to permitting its customers to debit accounts to pay merchants that also have accounts with the entity, the entity may issue

debit cards to account-holding customers or merchants that may be used outside the entity/system and the transactions of which are processed over four-party systems. Under these circumstances, the entity is an issuer with respect to electronic debit transactions that are initiated using the debit card. If the entity, together with its affiliates, has assets of $10 billion or more, then the interchange fee restrictions apply to the entity. The network exclusivity and routing provisions will apply regardless of the entity's asset size.

**c. Emerging technologies that access existing networks**

Another category of emerging payments technology is new access devices used to initiate debit card transactions processed over existing payment card networks. For example, many networks have approved the use of contactless devices to initiate transactions processed over their networks. These contactless devices may be issued as a separate card or included on or accessible through a mobile phone. The Board received comments both supporting and opposing application of the Board's rule to such new devices. The Board has considered the comments and has determined that new or emerging access devices are included within the scope of the proposed rule if they are issued or approved for use through a payment card network and otherwise meet the criteria for being a debit card as the term is defined in this rule (e.g., the card, code, or device debits the cardholder's account or a general-use prepaid card). New and emerging access devices are discussed more fully in the context of § 235.2(f)'s definition of "debit card" and the network exclusivity and routing provisions in § 235.7.

**N. Section 235.2(n) – Person**

The Board proposed to define "person" to mean "a natural person or an organization, including a corporation, government agency, estate, trust, partnership, proprietorship,

cooperative, or association." The Board received no comments on its proposed definition of "person" and has adopted the definition as proposed.

**O. Section 235.2(o) – Processor**

The Board proposed to define the term "processor" to mean "a person that processes or routes electronic debit transactions for issuers, acquirers, or merchants." One commenter suggested that the definition of processor be expanded to include processors that process on behalf of ATM operators. The Board does not consider ATM operators to be merchants for purposes of this rule. Additionally, ATM networks and transactions are not "payment card networks" or "electronic debit transactions," respectively, for purposes of this rule. Therefore, the Board has not expanded the definition of "processor" to include those processors that process on behalf of ATM operators. The Board has adopted the definition of "processor" as proposed and its associated commentary with minor clarifying revisions.

**P. Section 235.2(p) – Route**

The Board did not propose to define the term "route." One commenter suggested the Board define the term "network routing" to mean "the act of routing a transaction from the point of sale to point of authorization," but to exclude from the meaning of "network routing" any settlement or dispute handling functions unless the network and the gateway is the same entity. The Board is unaware of whether payment card networks currently permit entities to handle settlement and disputes through different entities than those through which the transaction was initially routed. Under § 235.7 of the final rule, such a rule would not be prohibited.

The Board is adding a definition of the term "route" in § 235.2(p). EFTA Section 920 uses the term "route" in the definition of "payment card network" and requires the Board to prescribe regulations that prohibit issuers and networks from inhibiting the ability of merchants

to "direct the routing" of electronic debit transactions. EFTA Section 920 does not define "route" or "routing." The Board also is not aware of other statutes that use those terms in similar contexts.

As discussed above in connection with § 235.2(m), the term "route" is commonly defined as "to send by a certain [or selected] route" or "to divert in a specified direction."[97] In other words, routing suggests involvement other than merely receiving and using information and data; specifically, it involves sending the information and data to another point or destination. These definitions apply to the term "route" in the context of electronic debit transactions.

In a four-party system, when a merchant accepts a debit card as a form of payment, the merchant sends the transaction information to its acquirer or processor. The acquirer or processor uses the transaction information to determine the network(s) over which it may send the transaction. For example, for signature-based transactions, the acquirer or processor looks to the first number in the BIN and directs the transaction to the appropriate network. The network then directs the transaction to the appropriate issuer. For PIN-based transactions, the acquirer or processor usually compares the information received from the merchant to "BIN tables," which the acquirer or processor uses to determine the networks over which transactions initiated by cards with various BINs may be routed. The acquirer or processor then sends the transaction over the appropriate network, which, in turn, sends the information to the appropriate issuer. Each party that receives the information must select the path the information will take to reach the entity to which it is sending the information and data.

Therefore, the Board has defined the term "route" in § 235.2(p) to mean "to direct and send information and data to an unaffiliated entity or to an affiliated entity acting on behalf of the

[97] *See, e.g.*, *Webster's New World Dictionary and Thesaurus* at 558 (2d ed. 2002); *Merriam Webster's Collegiate Dictionary* at 1021 (10th ed. 1993).

unaffiliated entity." Comment 2(p)-1 explains that the point to which a party directs or sends the information may be a payment card network or processor (if the entity directing or sending the information is an acquirer), or an issuer or processor acting on behalf of the issuer (if the entity directing and sending the information is a payment card network). As a result, an entity does not route information and data if the entity merely sends the information and data to affiliated book-keeping entities within itself.

As stated in the discussion on the scope of this part, three-party systems are not payment card networks because they do not "route" information to another point. Rather, a three-party system receives the transaction information and processes the information internally in order to authorize and settle the transaction.

**Q. Section 235.2(q) – United States**

The Board proposed to define "United States" to mean "the States, territories, and possessions of the United States, the District of Columbia, the Commonwealth of Puerto Rico, or any political subdivision of any of the foregoing." One network-commenter suggested that the Board limit its definition of "United States" to the 50 states plus the District of Columbia in order to minimize the costs associated with reprogramming. This commenter also noted that if the Board includes U.S. territories, the Board should survey issuers in those territories regarding their costs.[98]

[98] Based on information available to the Board, the Board distributed surveys to an institution that, together with its affiliates, had assets of more than $10 billion and that filed one of the following reports: the Consolidated Financial Statements for Bank Holding Companies (FR Y-9C; OMB No. 7100-0128), the Consolidated Reports of Condition and Income (Call Reports) for independent commercial banks (FFIEC 031 & 041; OMB No. 7100-0036), the Reports of Assets and Liabilities of and for U.S. branches and agencies of foreign banks (FFIEC 002; OMB No. 7100-0032), the Thrift Financial Reports (OTS 1313; OMB No. 1550-0023) for thrift holding companies and thrift institutions, and the Credit Union Reports of Condition and Income (NCUA 5300/5300S; OMB No. 3133-0004) for credit unions.

The Board proposed a definition of the term "United States" that is consistent with the EFTA's definition of "State."[99] The definition of "account" in § 235.2(a) is limited to accounts that are held in the United States and the definition of "electronic debit transaction" to those transactions accepted as a form of payment in the United States because the EFTA provides no indication (such as a conflicts of law provision) that Congress intended for Section 920 to apply to international transactions (i.e., those where the merchant or account debited is located in a foreign country).[100] Accordingly, limiting the scope of this part to transactions initiated at United States merchants to debit accounts in the United States avoids both extraterritorial application of this part as well as conflicts of laws. By contrast, including the Commonwealth of Puerto Rico and other territories or possessions of the United States does not implicate the same extraterritorial application concerns because the EFTA already applies to these jurisdictions. Therefore, the Board has not revised its definition of "United States," now designated as § 235.2(q).

## III. § 235.3 Reasonable and proportional interchange transaction fees

Section 235.3 sets forth a standard for assessing whether the amount of any interchange transaction fee that an issuer receives or charges with respect to an electronic debit transaction is reasonable and proportional to the cost incurred by the issuer with respect to the transaction for purposes of EFTA Section 920(a)(2). Under § 235.3(b), an issuer may not charge or receive any interchange transaction fee that exceeds the sum of 21 cents plus 5 basis points of the transaction's value.

### A. Summary of proposal and comments

[99] 15 U.S.C. 1693a(10).
[100] Interchange fees for electronic debit transactions initiated in a foreign country also may be subject to restrictions imposed by that country.

The Board requested comment on two alternative standards for determining whether the amount of an interchange transaction fee is reasonable and proportional to the cost incurred by the issuer with respect to the transaction. Under proposed Alternative 1, an issuer could comply with the standard for interchange fees by calculating its allowable costs and receiving an interchange fee that does not exceed its per-transaction allowable costs, up to a cap of 12 cents per transaction. An issuer's allowable costs with respect to each transaction would be the sum of those costs that are attributable to the issuer's role in authorization, clearance, and settlement of an electronic debit transaction and that vary with the number of transactions sent to the issuer within a calendar year (variable costs) divided by the number of electronic debit transactions on which the issuer received or charged an interchange transaction fee during that year (average variable cost). The proposal defined the issuer's role in authorization, clearance, and settlement as receiving and processing authorization requests (including voice authorization and referral inquiries); receiving and processing presentments and representments; initiating, receiving, and processing chargebacks, adjustments, and similar transactions; transmitting and receiving funds for interbank settlement; and posting electronic debit transactions to cardholders' accounts. Alternative 1 also would permit an issuer to receive or charge an interchange fee that does not exceed a safe harbor amount of 7 cents per transaction without demonstrating costs. Under Alternative 2, an issuer would comply with the standard for interchange fees as long as it does not receive or charge an interchange fee in excess of 12 cents per transaction. All of the proposed amounts were based on cost data for issuers responding to a Board survey in which those issuers reported information related to their transaction costs.

The Board received numerous comments on all aspects of its proposed interchange fee standards. Merchants and their trade groups overwhelmingly supported adoption of the

framework in Alternative 1 because that proposed standard would result in the greatest reduction from the current interchange fees (the savings of which could potentially be passed on to consumers as lower retail prices).[101] A few individual commenters supported the position of merchants and their trade groups. Issuers, many consumers, and payment card networks, on the other hand, opposed both proposed interchange fee standards for a variety of reasons, arguing that the limits in the proposals were not compelled by statute and expressing concerns that either of the proposed alternatives would decrease revenue to issuing banks, result in increased cardholder fees or decreased availability of debit card services, reduce benefits to merchants when compared to other forms of payment, and stifle innovation in the payment system, among other things.

The Board received numerous comments, primarily from issuers and networks, on its proposed interpretation of the meaning of "reasonable" and "proportional" to cost in Section 920(a)(2).[102] Issuers and networks asserted that the Board was bound by, or at least should look to, the jurisprudence surrounding the phrase, "just and reasonable," used in connection with ratemaking for public utilities or other regulated entities. These commenters argued that, by referring to fees that are "reasonable" and "proportional" to cost, Congress intended the Board to follow ratemaking jurisprudence that requires full recovery of costs (including depreciation) and a reasonable return on the rate base (asserted by the commenters to be the entire debit card program cost). These commenters argued that an interchange fee standard must be adopted in accordance with the ratemaking jurisprudence in order to avoid a violation of the takings prohibition in the Fifth Amendment to the U.S. Constitution. Issuers and networks believed that

[101] Several merchant-commenters stated that they saw no need for any interchange fees and that debit card transactions should clear at par like check transactions.

[102] In general, unlike issuers and networks, merchants and their representatives did not comment in detail about the meaning of the phrase "reasonable" and "proportional" to the cost.

the failure to consider the recovery of all types of costs plus a reasonable profit for all issuers (including those with allowable costs above the level of the proposed cap), as well as the Board's proposed consideration of an issuer's ability to recover costs from consumers, were inconsistent with the ratemaking jurisprudence. More generally, these issuers and networks objected to any cap that would not permit each covered issuer to recover the entire amount of its allowable costs.

By contrast, merchants and their trade groups argued that debit cards are only one part of a checking account product, that issuers do not need to obtain full cost recovery from merchants through interchange fees, and that robust debit card markets exist in other countries that have low or no interchange fees. Therefore, merchants and their representatives supported the proposal to limit allowable costs to a narrow group of costs associated mainly with authorization, clearance, and settlement of a transaction and to establish a cap at a level that does not permit 100 percent of covered issuers to recover allowable costs through interchange fees.

Other issuers and networks suggested that the Board should not follow the ratemaking jurisprudence because, unlike public utilities, no natural monopoly exists for issuers, which eliminates the risks of excessive profits and charges (as issuers do not have captive customers). Some of these commenters suggested how the Board should interpret the phrase "reasonable and proportional to the cost incurred by the issuer" independent from ratemaking jurisprudence. Many of these commenters read EFTA Section 920(a)(2) as requiring interchange fees that are in "reasonable proportion" to the issuer's cost of the transaction. Several issuers and networks contended that an interchange fee was not "reasonable" unless the fee included profit or a mark-up on cost. A few commenters argued that Congress demonstrated its intent that issuers be permitted to receive or charge interchange transaction fees that exceeded their costs by using the phrase "proportional to" rather than "equal to." One commenter contended that the

“reasonableness” of a fee should vary based on the scope of allowable costs. For example, reasonableness may be a different standard when compared to total cost than when compared to average variable cost. Other commenters viewed reasonableness independently from proportionality and suggested that the “reasonableness” of a fee take into consideration the benefits (or value) of debit cards to consumers and merchants (particularly through the analogy to checks).

Numerous issuers, networks, depository institution trade organizations, and individuals objected to fee limits as inconsistent with the directive that the Board establish “standards for assessing” whether the amount of an interchange fee is reasonable and proportional to cost. These commenters objected to the establishment of both the safe harbor and the cap because both involved numerical limits rather than subjective or flexible standards for assessing whether a fee was reasonable and proportional to cost. Few of these commenters provided specific suggestions about structuring the more flexible standards (other than eliminating the proposed cap). One issuer suggested that the Board specify the allowable costs and then specify how interchange fees may be structured to account for the variation in risk associated with different types of transactions. This commenter suggested that the Board specify how to determine a reasonable rate of return and that each network could gather cost information from each covered issuer in order to determine permissible interchange fees. A few commenters suggested the Board follow the approach used in its Regulation Z to interpret similar language in section 149 of the Truth in Lending Act (TILA), which did not set specific numerical limits, but did include safe harbor fee levels.[103]

[103] *See* 12 CFR 226.52(b)(1) (an issuer may impose a fee that “represents a reasonable proportion of the total costs incurred by the card issuer for that type of violation”).

Merchants supported a cap as necessary to prevent interchange fees from becoming excessively high, but objected to a safe harbor as inconsistent with the statutory language, which they viewed as requiring a connection to each issuer's specific costs. Some commenters argued that a cap involves an arbitrary limit on interchange fees and would be an unauthorized assessment of the reasonableness of the level of costs rather than of interchange fees. Other commenters contended that a single cap creates a variable relationship between interchange fees and costs across issuers, rather than a uniform proportional relationship.

A few commenters contended that the Board had no statutory basis for considering incentives to reduce costs. These commenters argued that issuers always have such incentives, and therefore a cap was not necessary to create such incentives. A few commenters also argued that any cap on cost recovery would ultimately reduce efficiency gains by discouraging firms from investing capital needed to achieve efficiency gains if those investments were not recovered under the cap.

One commenter argued that a cap was unnecessary in light of the network exclusivity and routing restrictions and believed that a cap would distort the market outcome of those provisions. By contrast, some merchants did not believe that the network exclusivity and routing provisions would result in significant downward pressure on interchange fee levels under proposed Alternative A.

Many of the commenters opposed to a cap and/or safe harbor, however, recognized the appeal of a cap or a safe harbor from the perspective of transparency and administrative simplicity and stated that a pure issuer-specific standard would be difficult to implement operationally and difficult to enforce. Merchants and one acquirer/processor acknowledged that having either a cap or a safe harbor would make the interchange fee structure simpler for

merchants to understand, which could increase transparency and reduce operational risks. One network asserted that an issuer-specific approach would result in unpredictable interchange fees for merchants because merchants would not know in advance the issuers of their customers' debit cards.

As between proposed Alternative 1 and 2, most issuers viewed Alternative 2 as the better alternative due to its ease of compliance, but preferred a higher cap. Other issuers supported a variant of Alternative 1—issuer-specific standards with a higher safe harbor and no cap. Issuers supported raising the cap and/or safe harbor to ensure recovery of costs such as the payment "guarantee," network processing fees, customer service costs, rewards programs, fixed costs, and a return on investment.[104] A few issuers suggested that any inclusion of the payment guarantee and fraud losses be done on an *ad valorem* basis and vary by merchant type.

Merchants and their representatives generally supported the more issuer-specific Alternative 1 as most consistent with the statute and reflective of the actual costs of most covered issuers, which they asserted are significantly below both the proposed 12-cent cap and 7-cent safe harbor.[105] Some acquirers and merchant processors acknowledged that Alternative 2 would be the easier alternative to implement, but objected to a safe harbor as inconsistent with the statute. Many of these commenters encouraged the Board to revise any safe harbor to base it on the mean cost across transactions rather than the median issuer cost in order to provide a greater link between costs and fees for most transactions, as well as greater incentives to lower costs.

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[104] Allowable costs are discussed in more detail later in this section. Many issuers, both covered by and exempt from the interchange fee standards, provided information in their comment letters about their estimated costs of debit card transactions, derived from internal accounting or industry studies. These costs generally ranged from 14 cents per transaction to 63 cents per transaction. A few commenters provided information about the cost components of these estimates.

[105] Several merchant commenters referenced a 2004 industry study (STAR CHEK Direct Product Overview study; First Annapolis Consulting) that found the per-transaction costs to be 0.33 cents for PIN debit and 1.36 cents for signature debit, but the study was not provided with the comments.

One commenter asserted that the average-cost measurement is more "economically meaningful" than the median. Most merchants objected to an *ad valorem* component.

## B. Final interchange fee standard

### 1. Description of final rule

The Board has considered all of the comments it has received and has determined to adopt in the final rule a modified version of the approach in proposed Alternative 2. Under the final rule, each issuer could receive interchange fees that do not exceed the sum of the permissible base component and the permissible *ad valorem* component. The standard's base amount per transaction is 21 cents, which corresponds to the per-transaction allowable cost, excluding fraud losses, of the issuer at the 80$^{th}$ percentile, based on data collected by the Board in a survey of covered issuers. The *ad valorem* amount is 5 basis points of the transaction's value, which corresponds to the average per-transaction fraud losses of the median issuer, based on the same survey data. Each issuer's supervisor is responsible for verifying that an issuer does not receive interchange fee revenue in excess of that permitted. *See* § 235.9. The Board recognizes that issuers' costs may change over time, and the Board anticipates that it will periodically conduct surveys of covered issuers in order to reexamine and potentially reset the fee standard.

### 2. Reasonable and proportional to cost

EFTA Section 920(a)(2) does not clearly require either transaction-specific or issuer-specific standards. Section 920(a)(2) provides that "the amount of any interchange transaction fee that an issuer may receive or charge with respect to an electronic debit transaction shall be reasonable and proportional to the cost incurred by the issuer with respect to the transaction." Some commenters interpreted this language as limiting the permissible interchange fee amount for a particular issuer to a proportion of the allowable costs incurred by that issuer. Other

commenters interpreted this language as permitting the permissible interchange fee amount to be set in accordance with the allowable costs of the average issuer or an issuer at a reasonable ranking among issuers. Nearly all commenters appear to believe the language did not require computing the actual allowable cost of each specific transaction; none argued for such a calculation. Instead, commenters generally interpreted Section 920(a)(2) as referring to the cost of an average electronic debit transaction or type of electronic debit transaction (e.g., PIN vs. signature) or some other categorization of the transaction (e.g., card-present vs. card-non-present).

The two proposals offered for comment by the Board covered both interpretations. Alternative 1 included an issuer-specific measurement of costs and fees. Alternative 2 was based on the average costs incurred by an issuer at the 80$^{th}$ percentile of allowable costs, based on certain survey data. As noted above, after consideration of the language and purpose of the statute and the practical results of various interpretations of the statute, the Board is adopting in the final rule a variant of the approach proposed as Alternative 2. Under this approach, an issuer may not receive an interchange fee that exceeds the sum of a base component, corresponding to the per-transaction allowable costs of the issuer at the 80$^{th}$ percentile as reported on the Board's survey, and an *ad valorem* component, corresponding to the per-transaction fraud loss of the median issuer as reported on the Board's survey.

As an initial matter, the Board believes this approach is consistent with the language in Section 920(a)(2). Section 920(a)(2) refers to "an issuer" and "an electronic debit transaction;" in other words, to a representative issuer and transaction. Section 920(a)(2)'s subsequent use of "the issuer" and "the transaction" is reasonably read as a reference back to the original representative use of each term (i.e., an issuer receiving an interchange fee and a transaction for

which a fee is received). This reading fulfills the purposes of the provision by allowing a standard to be set that ensures that interchange transaction fees are reasonable and are proportional to allowable costs without imposing undue compliance burdens on issuers or networks. This approach also provides transparency to issuers, networks, acquirers, merchants, and supervisors that will result in the most effective monitoring and enforcement of compliance.

The Board considered an alternative interpretation of Section 920(a)(2) under which the section would require that each interchange fee that a particular covered issuer receives be reasonable and proportional to the cost incurred by that issuer for the particular transaction for which the issuer is receiving the interchange fee. This reading, however, would result in a statutory requirement that is virtually impossible to implement. First, interchange fees are computed at the time of the transaction, and an issuer's costs for a specific transaction cannot be ascertained at the time the issuer receives the interchange fee. The cost of each transaction varies based on a variety of factors, including factors that may not be known to the issuer at the time it charges or receives the interchange fee. For example, the cost of network fees for a transaction may vary based on the volume of transactions that the issuer processes through a given network. The issuer cannot precisely control or know the volume of transactions at any given moment when a particular transaction occurs, because that volume depends largely on customer usage of their debit cards and merchant routing decisions; for example, lower transaction volume may result in higher network fees for each transaction.

Second, even assuming an issuer could calculate the cost of each transaction, transaction-specific interchange fees would result in an exceedingly complex matrix of interchange fees. Each issuer would be required to provide each network with data reflecting that issuer's actual cost per transaction, and each network would then be required to ensure that no more than the

allowable portion of these actual costs would be covered by an interchange fee. These calculations would be required for tens of billions of electronic debit transactions and a large and growing number of covered issuers.[106] This would introduce tremendous complexity and administrative costs for issuers, networks, acquirers, and merchants, as well as difficulty in monitoring and enforcing compliance. Thus, interpreting Section 920(a)(2) as requiring interchange fees to be calculated based on the cost of each transaction for which an interchange fee is charged or received would be an absurd result the Board does not believe Congress intended.[107]

This impractical result is not compelled by the words of Section 920(a)(2). As explained above, Section 920(a)(2) may be reasonably read to limit interchange fees based on the allowable costs for a representative issuer in a representative electronic debit transaction.

Some commenters urged adoption of an interpretation of Section 920(a)(2) that focuses on the costs incurred by a specific issuer in connection with a representative electronic debit transaction. This view, however, does not represent a consistent reading of the words of Section 920(a)(2). As noted above, Section 920(a)(2) refers to "an issuer" and "an electronic debit transaction" when identifying the amount of a fee that shall be restricted. Later, Section 920(a)(2) refers to both the cost incurred by "the issuer" and the cost of "the transaction." If "the issuer" in this second location is interpreted not as a reference to the original representative issuer, but instead as a reference to a *specific* issuer, then the same interpretation would seem to be required by the identical and parallel references to "a transaction" and "the transaction" in that

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[106] According to the Board's survey, there were 37.6 billion electronic debit transactions in 2009. The Board sent the survey to 131 covered financial organizations (some of which represented multiple affiliated issuers). The issuers responding to the survey, which does not cover the universe of covered issuers, accounted for about 60 percent of these transactions—roughly 22.6 billion transactions.

[107] In general, statutes should be interpreted to avoid an absurd result. *See Harrison v. Benchmark Elecs. Huntsville, Inc.*, 593 F.3d 1206, 1212 (11th Cir. 2010).

same sentence. As explained above, this leads to an extraordinarily complex and burdensome result. Commenters recognized this in supporting an interpretation of "a transaction" and "the transaction" as both referring to a representative electronic debit transaction, distinguishing electronic debit transactions and the costs related to those transactions from the costs related to other types of transactions, such as credit card transactions. In the same way, the parallel use of the same construction in referencing "an issuer" and "the issuer" in the same sentence supports the interpretation of those references as references to a representative issuer of debit cards.

Moreover, establishing issuer-specific interchange fee standards would significantly increase the burden on supervisors to assess compliance and make it impossible for networks, acquirers, and merchants to know whether issuers were in compliance with the standards under Section 920. Under any issuer-specific framework, each supervisor would need to determine for each transaction whether an issuer is receiving an interchange fee that does not exceed its allowable costs. Further, in contrast to the adopted approach that includes a publicly known maximum permissible fee, an issuer-specific approach would introduce uncertainty for networks and merchants, neither of which would know whether interchange fees received or charged by a given issuer were in compliance with the statutory standard. In addition, this approach would not create the incentive to reduce costs that is created by an approach like Alternative 2.

Section 920(a)(2) raises a second definitional matter. Section 920(a)(2) requires that the amount of any interchange fee be "reasonable" and "proportional to the cost incurred by the issuer," without defining either "reasonable" or "proportional." Instead, Section 920(a)(3) requires the Board to give meaning to those terms through its standards. For purposes of establishing standards for assessing whether the amount of any interchange fee is "reasonable" and "proportional" to cost, the Board has established a reasonable limit on the highest amount of

an interchange fee that an issuer may receive and has based that limit on the average per-transaction allowable costs incurred by issuers with respect to electronic debit transactions.

This approach gives meaning and effect to both terms. The statute's use of the term "reasonable" implies that, above some amount, an interchange fee is not reasonable. The term "reasonable" commonly is defined as meaning "fair, proper, or moderate" or "not excessive," and what is "reasonable" generally depends on the facts and circumstances.[108] Section 920(a) does not specify whether reasonableness is assessed from the merchant's or issuer's perspective or from another perspective. The use of the term "proportional" requires a relationship between the interchange fee and costs incurred; however, it does not require equality of fees and costs or demand that the relationship be constant across all quantities. The term "proportional" has a variety of meanings, including "forming a relationship with other parts or quantities" or "corresponding in degree, size, or intensity."[109] The final rule adopts a standard for both terms: a cap that delineates a separation between a "reasonable" fee and a fee that is not reasonable; and a requirement that the relationship between the amount of an interchange fee that may be received by an issuer and the cost of the transaction be set by reference to the allowable costs of electronic debit transactions.

In establishing this standard, the Board rejected a more mathematical interpretation of the word "proportional" that would require a constant proportion between costs and fees. As explained above, that reading is not required to give meaning to the term "proportional" in the statute. As interpreted by the Board, the term eliminates quantities that do not have the required relationship—in this case, excluding costs that are not related to electronic debit transactions.

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[108] *Black's Law Dictionary* at 1272 (7th ed. 1999) (defining "reasonable"); *Webster's New World Dictionary & Thesaurus* at 529 (2nd Ed. 2002) (defining "reasonable").

[109] *American Heritage Dictionary* at 1049 (1976); *Merriam Webster's Collegiate Dictionary* at 936 (10th ed. 1995) (defining "proportional").

Moreover, the term "proportional" is a meaningful and descriptive alternative to "equal to." In this way, Congress indicated that interchange fees must have a relationship to related costs, but need not be equal to those costs. Had Congress intended a fixed proportion between an issuer's transaction cost and the amount of an interchange fee, Congress could have required an interchange fee to have a "given proportion to," "be equal to," or have a "fixed proportion to" cost.

Several commenters suggested the Board follow an approach similar to the rules prescribed under Section 149 of the Truth in Lending Act, which uses language similar to EFTA Section 920(a)(2) and requires that penalty fees assessed by credit card issuers be reasonable and proportional to the omission with respect to, or violation of, the cardholder agreement.[110] Section 149 of TILA required the Board to consider the costs incurred by issuers as a result of credit card violations in addition to other factors, which included the need to deter violations. Under the Board's TILA rule, a penalty fee is reasonable and proportional to the omission or violation if the penalty fee is a reasonable proportion of the creditor's total cost of addressing that type of omission or violation for all consumers, which ensures that no individual consumer bears an unreasonable or disproportionate share of the creditor's costs of the type of violation. That rule establishes a safe harbor for compliance with the Board's standards, but does not establish a cap on the amount of penalty fees.[111]

The Board believes the context and usage of the terms "reasonable" and "proportional" in Section 149 of TILA and Section 920 of the EFTA allow for different approaches to effectuate the specific purposes of each section. The reference in TILA incorporates a subjective determination, relating to the proportionality of a fee to the violations of a contract, while the

[110] 15 U.S.C. § 1665d.
[111] 12 CFR 226.52; 75 FR 37527 (June 29, 2010).

reference in Section 920 relates to the proportionality of a fee to a numerical cost. In the Board's TILA standards, "a reasonable proportion" is based on a creditor's total cost of all violations of that type, and is readily set based on the costs to the creditor and monitored by supervisors, with variation across creditors reinforcing competition to the benefit of consumers. In the case of penalty fees regulated by TILA, the consumer paying the fee may stop its relationship with the creditor charging the fee.

Although that approach may be permissible under Section 920, the Board believes for the reasons discussed above that a single cap is a more appropriate approach in the context of interchange fees. In particular, practical implementation concerns, constraints on the data currently available to the Board, lack of competition in interchange fees, more effective and consistent monitoring, and other factors justify a different approach than the interpretation under TILA. Accordingly, the Board does not believe interpreting "proportional to" the same way in both the interchange fee context and the credit card penalty fee contexts is appropriate.

Based on the interpretations discussed above, the standard set in the final rule assesses whether an interchange fee is reasonable and proportional to costs by reference to certain average per-transaction costs directly related to particular electronic debit transactions of covered issuers. As explained below, in setting the cap, the Board relied on data that were available to it through its survey, and the Board included only certain issuer costs directly related to effecting particular electronic debit transactions. The Board did not consider any costs of processing credit card transactions, ACH transactions, or other transactions that access a cardholder's account (but did consider a pro rata portion of certain costs that are joint between debit cards and credit cards, or between debit card and other transactions that access a cardholder's account). Similarly, the Board did not consider corporate overhead or other costs, whether or not related to debit cards,

that are not related to particular electronic debit transactions (such as advertising and marketing costs for debit card programs). By so limiting the considerations, the Board ensures that the amount of an interchange fee is related to issuers' costs of effecting the electronic debit transaction and not to other factors.

### 3. Cost considerations

EFTA Section 920(a)(4)(A) requires the Board to consider the "functional similarity" between electronic debit transactions and checking transactions that are required within the Federal Reserve System to clear at par. Section 920(a)(4)(B) requires the Board to distinguish between "the incremental cost incurred by an issuer for the role of the issuer in the authorization, clearance, or settlement of a particular electronic debit transaction," and "other costs incurred by an issuer which are not specific to a particular electronic debit transaction." The statute directs the Board to consider the former costs in establishing an interchange fee standard, and prohibits it from considering the latter costs. The Board interprets the prohibition in Section 920(a)(4)(B)(ii) on considering certain costs as prohibiting *inclusion* of these costs in the standards set under Section 920(a)(3), and not as a prohibition on the Board collecting information about and determining the scope of these costs.

Beyond these instructions, as explained below, Section 920 does not restrict the factors the Board may consider in establishing standards for assessing whether interchange transaction fees are reasonable and proportional to cost, such as costs that are specific to a particular electronic debit transaction but are not incremental or are not related to the issuer's role in authorization, clearance, and settlement. As explained below, the Board carefully evaluated the costs that could be considered under Section 920(a)(4) as well as the data available regarding these costs in establishing a standard for determining whether an interchange fee is reasonable

and proportional to cost, and did not include costs prohibited by Section 920(a)(4)(B)(ii) in establishing the interchange fee standard.

**a. Summary of proposal**

The Board proposed standards for interchange fees that are based on the per-transaction costs an issuer incurs only for authorization, clearance, and settlement and that vary with the number of transactions within the reporting period (i.e., average variable cost). The proposal excluded network processing fees, as well as other costs not related to authorization, clearance, and settlement that varied with the number of transactions. The proposal also excluded all costs that did not vary with changes in transaction volumes up to capacity limits within a calendar year. *See* proposed comment 3(c)-3.i. Under the proposal, an issuer could allocate a pro rata share of debit card costs included among variable costs of authorization, clearance, and settlement that were shared with credit card or other programs.

The Board based both of its fee standard alternatives on an issuer's per-transaction variable costs of authorization, clearance, and settlement. The regulatory text for Alternative 1, which incorporated an issuer-specific cost component, included a detailed description of allowable costs. Proposed § 235.3(c)(1) described the exclusive list of allowable costs as including the costs that are attributable to receiving and processing authorization requests; receiving and processing presentments and representments; initiating, receiving, and processing chargebacks, adjustments, and similar transactions; transmitting and receiving funds for interbank settlement; and posting electronic debit transactions to cardholders' accounts. Proposed § 235.3(c)(2) stated that fees paid to a network were not an allowable cost. Proposed comment 3(c)-2.i clarified that, with respect to authorization, an issuer's allowable costs included costs for activities such as data processing, voice authorization and referral inquiries,

and did not include the costs of pre-authorization activities with the primary purpose of fraud prevention (e.g., transactions monitoring). Proposed comment 3(c)-2.ii explained that an issuer's clearance costs included costs for activities such as data processing and reconciling the clearing message. With respect to non-routine transactions, proposed comment 3(c)-2.iii explained that an issuer's costs included data processing to prepare and send the chargeback, or other similar message and reconciliation expenses specific to non-routine transactions, but allowable costs did not include the costs of receiving cardholder inquiries about particular transactions. Finally, proposed comment 3(c)-2.iv explained that an issuer's settlement costs, for purposes of determining allowable costs, included fees for settling through a net settlement service, ACH, or Fedwire®, as well as data processing costs incurred for account posting.

**b. Summary of comments**

Merchants overwhelmingly supported the proposal to interpret the first consideration in Section 920(a)(4)(B) as limiting allowable costs to only the incremental costs of authorization, clearance, and settlement. One merchant trade group expressed a preference for including only authorization costs (noting that the statutory requirement to "consider" other costs did not require "inclusion" of those costs in allowable costs), but concluded that including clearance and settlement costs would also be permissible in light of the statutory mandate to consider those costs.

By contrast, issuers and networks advocated expanding the proposed set of allowable costs, asserting that Section 920(a)(4)(B) does not require that allowable costs be limited to the incremental costs of authorization, clearance, and settlement of a particular transaction. Issuers and networks suggested a variety of ways by which the Board could expand the set of allowable costs, such as by including an expanded definition of activities considered to be part of

authorization, clearance, and settlement; including more, or all, costs that are specific to a particular transaction, but not incurred for authorization, clearance, or settlement; including all costs associated with a debit card program; and including all costs associated with deposit accounts or general operations of the bank.[112] As further discussed below, many issuers suggested that other allowable costs could include costs of computer equipment and other capital assets, card production and delivery, customer service, statements, and resolution of billing errors, as well as an allowance for profit.

With respect to authorization, clearance, or settlement costs, many commenters believed that the proposal improperly limited the costs of authorization, clearance, and settlement to the costs of sending the message and funds between parties to a transaction.[113] In general, commenters suggested expanding the interpretation of authorization activities to include the costs of building, updating, and maintaining databases of cardholder information and behavior patterns that are necessary for determining whether the card and account are valid. In addition, numerous issuers suggested including the cost of monitoring transactions to determine whether a particular transaction is fraudulent, which one network noted could involve establishing and maintaining complex algorithms. (Transactions monitoring is discussed separately below.) Many issuers suggested including the network processing fees (e.g., switch fees) they pay for authorizing, clearing, and settling each transaction. Another issuer suggested including, as an authorization cost, the cost of PIN management, but did not elaborate as to what that activity

[112] Several commenters encouraged the Board to view settlement as not complete until after the period during which network rules permit an issuer to charge back a transaction has ended. As discussed in this section, adopting a specific definition of "authorization," "clearance" or "settlement" is unnecessary.
[113] A few commenters suggested that the Board expand allowable costs to include data processing costs of authorization, clearance, and settlement. The proposal included these costs to the extent the costs varied with the number of transactions sent to the issuer.

entailed. Numerous issuers suggested that the final rule include the cost or value of the payment guarantee as a cost of authorization. This feature is discussed separately below.

The Board received numerous comments on its proposed interpretation of the incremental cost of a particular transaction. Merchants, as well as a few other commenters, supported the use of average variable costs (i.e., the average value of those costs that vary with the number of transactions sent to an issuer within a calendar year). Issuers and networks generally opposed this interpretation of the incremental cost of a particular transaction, and several commenters offered alternative definitions of "incremental cost." Several commenters stated that "incremental cost" had a well-established meaning—the cost saved by a service provider if it did not provide the service, or the cost incurred to provide the service. Many issuers argued that the relevant service was debit card programs and, based on this proposed definition, suggested that all of the program's costs should be considered, including customer service costs, the cost of statements, costs from resolution of billing errors, card production and delivery, capital costs, and an allowance for profit, as well as account set-up costs.[114]

Other commenters argued that the proposal arbitrarily limited the period of time used for determining whether a given cost was "incremental." One commenter suggested that incremental costs include costs that varied over a multi-year period (e.g., 3-5 years). Still others asserted that the costs of debit card transactions can vary based on measures other than time, such as transaction volume (e.g., peak-load volumes); therefore, many in-house costs are variable with changes in transaction volume larger than one transaction. Among the costs commenters argued should be included because they vary over time or over other measures are customer service costs; equipment and other capital costs, labor costs, and overhead costs; network membership and gateway fees; debit program administration costs, including marketing;

[114] These and similar costs are discussed in more detail later in this section.

insurance costs; and research and development costs. These commenters contended that excluding consideration of these costs would encourage issuers to shift transaction processing to third-party processors that would convert all costs into incremental costs that vary with the number of transactions over the short term. Commenters argued that this result would be less efficient in the long run and could lead to higher interchange fees and customer costs. A few commenters argued that a broader reading of incremental costs was necessary to ensure that a cap would further general policy goals of efficiency and innovation, and contended that many efficiency gains and innovations cannot be achieved absent specific upfront investment. A few commenters argued that considering a broader range of costs would minimize barriers to entry and promote competition.

The Board also received numerous comments on the proposed distinction between costs that are specific to a particular transaction and costs that are not specific to a particular transaction for purposes of the considerations in Section 920(a)(4)(B). Commenters disagreed as to which costs were specific to a particular transaction and which costs were not. A few commenters suggested that issuers be permitted to recover certain transaction costs even if the cost is not paid for, charged, or incurred on a per-transaction basis. Costs that commenters suggested as being specific to a particular transaction included costs incurred for chargebacks, transaction-specific customer service inquiries, providing statements, providing rewards (and associated rewards-program administration), and depreciation. One commenter argued that any cost can be allocated to a specific transaction, and therefore the statute does not resolve which costs are specific to a transaction. Several commenters recognized that although any cost could be allocated to any transaction, the relationship of a cost to a particular electronic debit transaction varies.

In addition to the proposed interpretation of individual provisions, the Board received numerous comments about how Section 920(a)(2) and the considerations in Section 920(a)(4)(B) should be interpreted together. Some merchant commenters argued that the Board should interpret Section 920(a)(4)(B)(ii) as prohibiting inclusion of all costs that were not an incremental cost of authorization, clearance, and settlement. Several other commenters asserted that Section 920(a)(4)(B) is silent with respect to non-incremental costs associated with authorization, clearance, and settlement. Specifically, these commenters argued that Section 920(a)(4)(B)(i) addressed the incremental costs of authorization, clearance, and settlement of a particular transaction, Section 920(a)(4)(B)(ii) addressed costs that are not specific to a particular transaction, but neither paragraph addressed costs that were specific to a particular transaction but were not an incremental cost of authorization, clearance, and settlement. Other commenters argued that Section 920(a)(4)(B)(ii) excludes only costs that are not specific to electronic debit transactions in general, rather than costs that are not specific to a particular electronic debit transaction. Several issuers and networks asserted that Section 920(a)(4)(B) requires the Board only to "consider" some costs and that the cost considerations are not binding in the development of fee standards under Section 920(a)(2), which requires that the amount of an interchange fee be reasonable and proportional to "the cost incurred by the issuer with respect to the transaction." One depository institution trade group contended that there is no indication of Congressional intent that issuers not be able to recover all of the substantial costs incurred to provide debit card services.

**c. Overview of costs considered under the final rule**

EFTA Section 920(a)(4)(B) requires the Board to distinguish between two types of costs when establishing standards for determining whether the amount of any interchange fee is

reasonable and proportional to the cost incurred with respect to the transaction. In particular, Section 920(a)(4)(B) requires the Board to distinguish between "the incremental cost incurred by an issuer for the issuer's role in authorization, clearance, or settlement of a particular electronic debit transaction," which costs the statute requires the Board to consider, and "other costs incurred by an issuer which are not specific to a particular electronic debit transaction," which the statute prohibits the Board from considering.

Section 920(a)(4)(B) does not define which types of costs are "not specific to a particular electronic debit transaction." Therefore, the Board must define these costs. The Board had proposed to exclude from allowable costs those costs that cannot be attributed to any identified transaction (referred to as "fixed costs" in the proposal), even if those costs were specific to effecting debit card transactions as a whole.

Many commenters argued that this reading was not compelled by the statute, excluded costs that could be considered under the statute, and was an unworkable approach in practice. In particular, they argued that identifying whether a particular cost would not be incurred but for one particular transaction is an impractical approach to determining which costs not to consider because of the very large number of transactions many covered issuers process in a day or other time period. This volume makes it virtually impossible to attribute the actual cost of the activity (e.g., receiving messages) to one specific transaction.

Based on a consideration of these and other comments on the scope of the prohibition in Section 920(a)(4)(B)(ii), the Board has revisited its proposed interpretation of Section 920(a)(4)(B). The Board notes that this section is ambiguous and may be read in several ways. An interpretation that Section 920(a)(4)(B) prohibits consideration of all costs that are not able to be specifically identified to a given transaction would appear to exclude almost all costs related

to electronic debit transactions because very few costs could be specifically assigned to a given transaction.[115] Moreover, as many commenters noted, operational constraints make the determination of which in-house costs an issuer incurs in executing any particular transaction virtually impossible in practice.

Section 920(a)(4)(B) has another straightforward interpretation that is workable and gives important meaning to this section. This reading would interpret costs that "are not specific to a particular electronic debit transaction," and therefore cannot be considered by the Board, to mean those costs that are not incurred in the course of effecting any electronic debit transaction. The statute allows the Board to consider any cost that is *not* prohibited – i.e., any cost that *is* incurred in the course of effecting an electronic debit transaction. This interpretation would not require identification of the cost of a given electronic debit transaction. In this way, the interpretation gives life and meaning to the prohibition in Section 920(a)(4)(B)(ii) without creating the tremendous burdens and practical absurdities discussed by commenters and noted above. Examples of the costs the Board is prohibited from considering are discussed below.

As noted above, there exist costs that are not encompassed in either the set of costs the Board must consider under Section 920(a)(4)(B)(i), or the set of costs the Board may not consider under Section 920(a)(4)(B)(ii). These costs, on which the statute is silent, are those that are specific to a particular electronic debit transaction but that are not incremental costs related to the issuer's role in authorization, clearance, and settlement. Although Section 920(a) does not specifically instruct the Board on how these costs should be considered in establishing the debit interchange fee standard, the section does not prohibit their consideration. Indeed, the requirement that one set of costs be considered and another set of costs be excluded suggests that

[115] Network switch fees and issuer-processor per-transaction fees are among the few costs that could be assigned to individual transactions.

Congress left to the implementing agency discretion to consider costs that fall into neither category to the extent necessary and appropriate to fulfill the purposes of the statute. Had Congress intended otherwise, it would have prohibited consideration of all costs other than those required to be considered, rather than simply prohibiting consideration of a particular set of costs. Moreover, the statutory phrasing of the costs that must be considered and of the costs that may not be considered leaves no doubt that costs that are not within the category of prohibited costs and that are not incremental costs of authorization, clearance, and settlement may still be considered in establishing standards under Section 920(a).[116]

In discussing the costs that the Board is required to consider under Section 920(a)(B)(4)(i), the proposal noted that there is no single generally-accepted definition of the "incremental cost" of a particular unit of a service. As a result, the Board proposed to apply a definition to this term. The Board proposed to consider a cost to be an "incremental cost . . . of a particular transaction" for purposes of Section 920(a)(4)(B)(i) if the cost varied with the number of transactions sent to an issuer within a year.

Several commenters urged defining "incremental cost" as the difference between the cost incurred by a firm if it produces a particular quantity of a good and the cost incurred by the firm if it does not produce the good at all.[117] This definition would include any fixed or variable costs that are specific to the entire production run of the good and would be avoided if the good were not produced at all. Another definition of "incremental cost" suggested by commenters was the cost of producing some increment of output greater than a single unit but less than the entire

[116] The reference in Section 920(a)(4)(B)(i) requiring consideration of the incremental costs incurred in the "authorization, clearance, or settlement of a particular transaction" and the reference in Section 920(a)(4)(B)(ii) prohibiting consideration of costs that are "not specific to a particular electronic debit transaction," read together, recognize that there may be costs that are specific to a particular electronic debit transaction that are not incurred in the authorization, clearance, or settlement of that transaction.
[117] Baumol, William J., John C. Panzar, and Robert D. Willig (1982), *Contestable Markets and the Theory of Industry Structure*. New York: Harcourt Brace Jovanovich.

production run.[118] The Board noted in the proposal these definitions do not correspond to a per-transaction measure of incremental cost that could be applied to any particular transaction.

Other commenters urged the Board to interpret "incremental cost" as differentiating between "fixed" and "variable" costs. Although relying on the variable cost incurred by the issuer to authorize, clear, and settle an electronic debit transaction is a way to interpret the incremental cost of authorization, clearance, and settlement of a particular transaction, the meanings of fixed costs and variable costs depend on a variety of factors, and these concepts are difficult to apply in practice. As asserted by many commenters, whether a cost incurred by an issuer for authorization, clearance, and settlement of transactions is thought of as "fixed" or "variable" depends on the relevant time horizon and volume range. As applied to the proposed interchange fee standards, the same type of cost may appear variable in one year, but fixed in a different year. For example, if an increase in the number of transactions processed from one year to the next requires the acquisition of additional equipment in the second year, hardware costs that would be considered fixed in the first year would be variable in the second year.

Inconsistent treatment of the same type of cost would make tracking costs for purposes of reporting exceedingly difficult for issuers. This difficulty is compounded by the fact that, even if a clear line could be drawn between an issuer's costs that are variable and those that are fixed, issuers' cost-accounting systems are not generally set up to differentiate between fixed and variable costs. Rather, cost-accounting systems typically are used for internal management purposes, and determining which part of total costs is variable and which is fixed often requires a subjective judgment by the issuer. This fact could result in significant variation across issuers as to which costs are allowable and which are not.

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[118] Another interpretation of "incremental cost" would be marginal cost, often assumed to be, but not required to be, the additional cost of the last unit produced. The proposal highlighted the practical difficulties of measuring the marginal cost of a transaction. The Board did not receive comments regarding the use of marginal cost.

Moreover, nearly any cost that could be defined as fixed if incurred by an issuer that performs its transactions processing in-house could be considered as variable if the issuer were to outsource its debit card operations to a third-party processor that charged issuers a per-transaction fee based on its entire cost, including both fixed and variable costs. This makes enforcement of a distinction between fixed and variable costs very difficult and potentially uneven.

Commenters argued that an issuer incurs costs to effect an electronic debit transaction other than the variable authorization, clearance, and settlement costs the Board originally proposed to include as allowable costs. Specifically, issuers incur costs to connect to the network and to purchase and operate the hardware and software used for processing transactions, including associated labor cost. As stated above, these costs are not readily placed in the "variable" or "fixed" categories because their categorization depends on the relevant range of transactions and the time horizon. However, no electronic debit transaction can occur without incurring these costs, making them costs specific to each and every electronic debit transaction.

Many complexities also exist in attempting to define costs that are or are not "incurred by an issuer for the role of the issuer in the authorization, clearance, or settlement" of an electronic debit transaction under Section 920(a)(4)(B)(i). As noted above, many commenters disputed the proposed definition of authorization, clearance, and settlement as arbitrarily excluding costs related to dispute settlement and account set-up because these costs are incurred before or after the transaction has occurred. The Board considered these comments and included additional costs to the extent described below. The Board does not find it necessary to determine whether costs are "incremental," fixed or variable, or incurred in connection with authorization, clearance, and settlement. Under the framework established by the statute, all costs related to a

particular transaction *may* be considered, and some—the incremental costs incurred by the issuer for its role in authorization, clearance, and settlement—*must* be considered. In determining the interchange fee standard, the Board considered the authorization, clearance, and settlement costs described in the proposal for which data were available. By considering all costs for which it had data other than prohibited costs, the Board has complied with the statutory mandate not to consider costs identified in Section 920(a)(4)(B)(ii), has fulfilled the statutory mandate requiring consideration of the costs identified in Section 920(a)(4)(B)(i), and has chosen to consider other costs specific to particular electronic debit transactions to the extent consistent with the purpose of the statute, in establishing its standard required under Section 920(a)(3)(A).

### d. Examples of costs not included in setting the standard

On the basis described above, in establishing the standards for implementation of Section 920(a)(2), the Board did not include in the establishment of the interchange fee standard those costs that are not specific to a particular electronic debit transactions.[119] In addition, the Board did not include certain costs that are specific to a particular electronic debit transaction but are not incremental costs incurred by the issuer for its role in the authorization, clearance, and settlement of a particular transaction. The costs the Board did not consider in setting the standards include costs associated with corporate overhead or establishing and maintaining an account relationship; general debit card program costs, such as card production and delivery costs, marketing expenditures, and research and development costs; and costs for non-sufficient funds handling. Although the Board recognizes that all of these costs may in some way be related to debit card programs and transactions, the Board believes that many of these costs are not specific to a particular electronic debit transaction within the meaning of the prohibition in

[119] The Board also did not include a level of profit or a rate of return as an allowable cost in setting its standard. To the extent profit is a "cost," it is not one that is specific to a particular transaction.

Section 920(a)(4)(B)(ii) and therefore may not be considered by the Board. The Board has also determined not to include the costs resulting from non-sufficient funds, the costs of rewards programs, or costs of handling cardholder inquiries for various reasons discussed below.

*Corporate overhead and account relationship costs*. Corporate overhead costs incurred by an issuer for its general business operations are shared across all product lines of the issuer and are not specific to a particular electronic debit transaction. In fact, although a portion of these costs could relate to debit card programs, these costs are not specific to *any* electronic debit transaction because they are not incurred in the course of effecting electronic debit transactions. Corporate overhead costs include, but are not limited to, the costs of compensation for executive management; the costs of support functions such as legal, human resources, and internal audit; and the costs to operate the issuer's branch network.

Some commenters recommended the final rule include the costs of account set-up, including the costs of performing customer due diligence, enrolling the customer in on-line banking, and acquiring customers (e.g., through marketing). Costs that are incurred with respect to the cardholder account relationship are not specific to any electronic debit transaction. Once an account is established, an issuer may incur ongoing costs of maintaining the account and customer relationship, including costs of receiving and resolving certain account-related customer inquiries, account-related regulatory compliance cost (e.g., BSA/AML compliance, Regulation E compliance, and FDIC insurance),[120] and ATM-related costs. These costs are also not incurred in the course of effecting an electronic debit transaction, and, as with cardholder

[120] Federal, state, or local regulations that are not tied directly to the debit card program include Bank Secrecy Act/anti-money laundering (BSA/AML) regulations. Among other things, BSA/AML requires banks to report suspicious activity that might signify money laundering, tax evasion, or other criminal activities. 12 USC §§ 1829b and 1951-1959; 31 USC §§ 5311-5314, 5316-5332; 31 CFR part 1010.

account costs, would be incurred even if the customer engaged in no electronic debit transactions.

*Debit card program costs*. Many issuers and networks suggested that the final rule include all costs related to debit card programs. As noted above, those commenters urged the Board to read Section 920(a)(4)(B)(ii) to exclude only those costs that are not related to electronic debit transactions or the debit card program.

The Board's interpretation of the statute distinguishes between costs incurred in effecting electronic debit transactions and broader program costs. Card production and delivery costs were excluded because they are not incurred in the course of effecting electronic debit transactions. Although each debit card transaction uses a debit card or information from the debit card, an issuer's card production and delivery costs (e.g., creating plastic cards and alternate devices such as key fobs, and mailing them to cardholders) are incurred without regard to whether, how often, or in what way an electronic debit transaction will occur. For example, a customer may never use the debit card for an electronic debit transaction or may use the card only for ATM transactions (which are not covered by this rule). A customer may also use only the debit card number (as, for example, in Internet or preauthorized recurring electronic debit transactions) and not the card or alternate device provided by the issuer.

Excluding the cost of debit card production and delivery from the interchange fee charged to the acquirer is consistent with another requirement of Section 920(a). Section 920(a)(4)(A) requires the Board to consider the functional similarity between electronic debit transactions and check transactions. In the case of checks, the check-writer or his bank typically bears the cost of producing and obtaining blank checks.

An issuer's marketing costs and costs of research and development to improve its debit card products and programs are not costs that are specific to particular electronic debit transactions within the meaning of the statute. Marketing costs could include, for example, the cost of informing cardholders of the availability of optional debit card products and services, and the cost of advertising campaigns for the issuer's debit card program. Research and development costs could include, for example, costs related to debit card enhancements, process improvements, and debit card product development. In addition to not being costs specific to effecting particular electronic debit transactions, analogous costs incurred by a payor's bank for its check service are not reimbursed by the payee's bank.

Debit card issuers also incur costs in order to comply with Federal, state, or local regulations, including costs of providing account statements. Although the costs of providing statements relate to conducting electronic debit transactions generally, the statement relates to the entire account relationship and the total number of all types of transactions in the cardholder's account and is triggered by the account relationship as opposed to any specific transaction.[121] Moreover, analogous costs incurred by a payor's bank for its check service are not reimbursed by the payee's bank.

As explained below, the Board considered and determined to include network switch fees in establishing standards under Section 920(a). However, the Board did not include the cost of network membership. Although network membership is necessary in order to process transactions over a particular network, membership fees are not incurred each time a cardholder

[121] Some issuers argued that enabling a second, unaffiliated network on a debit card was a "compliance cost" (created by this rule). To the extent an issuer incurs costs related to enabling an unaffiliated network that are otherwise considered to be incurred in effecting an electronic debit transaction (e.g., network connectivity costs to comply with § 235.7), such costs would be included as a basis for the interchange fee standard.

uses a debit card and, in fact, are incurred for activities other than those related to particular electronic debit transactions, such as marketing and research and development.

*Payment guarantee and non-sufficient funds handling*. If an issuer authorizes an electronic debit transaction, network rules typically require the issuer to pay the transaction, subject to specific chargeback rights provided by network rules. One aspect of the issuer's obligation is the so-called "payment guarantee," which refers to network rules that specify that an issuer that authorizes a transaction may not return that transaction for insufficient funds or an invalid account. Several issuers and networks suggested including the cost of providing the payment guarantee as an authorization or settlement cost. Many of these commenters asserted that the payment guarantee that issuers provide merchants for electronic debit transactions is one of the primary differences between electronic debit transactions and checking transactions.

Commenters both in favor of and opposed to including the cost of the payment guarantee as an allowable cost stated that for check transactions merchants are able to purchase check verification and guarantee services. Commenters that supported including the cost of the payment guarantee as an allowable cost suggested that the Board measure the costs in terms of risk exposure, overdraft losses, or the value to the merchant (by considering the price merchants pay for comparable check verification and guarantee services). A few issuers asserted that if they were not compensated for the payment guarantee, then they should be permitted to return a transaction for insufficient funds.[122] More generally, some commenters noted that networks could change existing chargeback rights if issuers were not reimbursed for their costs incurred as part of the payment guarantee.

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[122] A few issuers suggested that, if the payment guarantee were not included in the base interchange fee, an issuer should be able to charge separately for the guarantee. However, if an issuer were to charge or receive a fee for a payment guarantee through a network, then such a fee would be an interchange transaction fee for purposes of this rule.

By contrast, other commenters (predominantly merchants) opposed including the cost of the payment guarantee as an allowable cost because, for check transactions, purchasing the verification or guarantee is optional and not required in order to accept checks. Merchants also stated that network rules permitted issuers to charge back transactions alleged to be fraudulent and therefore, the commenters argued, the payment guarantee was not really a guarantee. Some merchants also noted that they are constrained from taking certain steps to minimize fraud because payment card networks discourage merchants from checking the identification of the cardholders in order to reduce inconvenience associated with use of the card.

The Board has considered the comments received on payment guarantees. The final rule does not include the payment-guarantee cost (including non-sufficient funds handling) within the allowable costs. Losses that result from the payment guarantee are incurred when an issuer authorizes a transaction that overdraws the cardholder's account. However, losses associated with a debit card payment guarantee are largely within the issuer's control. An issuer is usually able to decline transactions for which there are insufficient funds, whereupon the merchant will not complete the transaction using the particular debit card. When an issuer approves an authorization request, it generally places a hold on the cardholder's funds pending settlement. If an issuer approves the transaction knowing there are insufficient funds in the account, or does not place a hold on funds underlying an approved transaction, the issuer is choosing to incur any costs incurred in obtaining funds from the cardholder. The issuer incurs this cost as a service to its cardholders, and generally imposes fees to recover the associated risk that a cardholder may fail to provide subsequent funding for the transaction.[123] Although some issuers argued that the

[123] There are some instances in which a transaction is not cleared until after the authorization hold expires (generally after three days), which may result in an overdraft that was not within the control of the issuer. Although this represents a cost to the issuer of the payment guarantee that is not caused by the issuer knowingly authorizing a nonsufficient funds transaction, the data are not available to separate these "NSF" costs from all other "NSF" costs.

payment guarantee is analogous to check-guarantee services for which the merchant pays, check guarantee services are generally provided by firms that do not hold the customers' accounts. Therefore, these guarantees are made based on less complete information and the fees for these services reflect this incremental risk.

*Cardholder rewards*. Issuers offer rewards to customers in order to promote use of the issuer's debit cards, and debit card networks develop these rewards programs to be offered by issuers in order to promote the use of the network's cards. The costs of the rewards and associated program administration depend upon the level of rewards the issuer deems desirable to effectively compete for account holders. Although an issuer may give cardholders rewards for each transaction (or value of transactions), this cost is a customer-relationship program cost that the issuer chooses to incur. Thus, rewards costs are more akin to marketing costs designed to attract customers to the issuer and the network than to transaction costs incurred in the course of effecting an electronic debit transaction.

Moreover, rewards programs often benefit a specific group of merchants determined by the debit card network or issuer. Including these costs in interchange fees that are charged to all merchants would amount to a subsidization of selected merchants by all other merchants that do not benefit from the rewards program (including competitor merchants). Although payor's banks typically do not offer rewards programs for the use of checks, an institution that chose to do so would bear the associated costs and would not receive reimbursement for these costs from the payee's bank. The Board has not included the costs of rewards in establishing the fee standard.

*Cardholder inquiries*. Issuers incur costs for activities necessary to receive and resolve cardholder inquiries before and after transactions. Issuers and networks argued that the costs of

handling customer inquiries and disputes should be included because such costs relate to a particular transaction. Moreover, issuers stated that not including these costs would eliminate incentives for issuers to provide anything but the minimum, legally mandated customer service.

Many costs related to cardholder inquiries do not relate to specific transactions. Rather, they relate to balance inquiries, reports of lost or stolen cards, requests for other replacement or additional cards, inquiries about ancillary products and services, and other non-transaction specific inquiries. In addition, issuers often take the opportunity of a cardholder inquiry to engage in marketing activities unrelated to any particular electronic debit transaction (or to debit programs generally).

However, some customer service inquiries relate to particular transactions. Fielding these inquiries is partly a cost of a service required by regulatory and network rule requirements and partly a cost of managing the customer relationship.

Payor's banks bear the costs associated with customer inquiries for check transactions and do not receive reimbursement for these costs from the payee's bank. Moreover, the cost data obtained by the Board in response to its issuer survey does not allow for the separation of the costs of cardholder inquiries related to specific transactions from the costs of inquiries that do not related to particular transactions. Thus, it is not currently possible to accurately separate out and assess cost data for customer inquiries related solely to particular debit transactions. Accordingly, the Board has not included the costs of cardholder inquiries in establishing the fee standard.

**e. Costs included in setting the standard**

The Board has included in its establishment of the interchange fee standard the following types of costs from its issuer survey: total transactions processing costs (including costs reported

as fixed and variable authorization, clearance, and settlement costs, network processing fees (e.g., switch fees), and the costs of processing chargebacks and other non-routine transactions), transactions monitoring, and fraud losses. An issuer may use the same processing platform for its debit card and credit card operations (or debit card and ATM card operations) to take advantage of economies of scope and scale. The costs of these activities and equipment are referred to as "joint costs" because they are shared. Joint costs between debit card and credit card programs may include network connectivity used for multiple card program activities; common hardware, software, and associated labor that are shared across card programs; and customer settlement applications used for all transaction account processing. In these cases, in the Board's survey, costs (excluding fraud losses) were allocated to electronic debit transactions on a pro rata basis. The costs the Board included in establishing the fee standard are discussed further below.

*Transactions processing*. In addition to the proposed allowable costs described in relation to proposed Alternative 1, an issuer must maintain and use network connectivity to effect each transaction because the issuer must be able to receive the particular authorization request, send the particular approval or denial message, and receive the related clearing and settlement message. Likewise, an issuer must maintain and use computer equipment that can process each authorization request by checking for the validity of the card and account, as well as checking and updating the amount of funds in an account. The issuer must also employ staff to operate and maintain the computer equipment involved in transaction processing. Each transaction uses the equipment, hardware, software and associated labor, and no particular transaction can occur without incurring these costs. Thus, these costs are "specific to a particular transaction." The most reasonable way to measure and allocate these costs on a per-transactions

basis is by averaging these costs across the total number of electronic debit transactions that use the resource.[124]

*Costs of chargebacks and other non-routine transactions.* Transactions are not limited to the initial purchase. An issuer may initiate a chargeback transaction to reverse settlement with both the acquirer and the cardholder, and an acquirer may present the transaction again to the issuer if the acquirer believes the issuer is not entitled to charge back the transaction.[125] The proposal included as allowable costs the costs of "initiating, receiving, and processing chargebacks, adjustments, and similar transactions" and the costs of "receiving and processing representments of electronic debit transactions" (but not the actual amount of the chargeback, adjustment, or representment. Proposed comment 3(c)-2.iii stated that an issuer's activities associated with non-routine transactions included activities such as data processing to prepare and send the chargeback message and reconciling the chargeback with the cardholder's account, but excluded costs of receiving cardholder inquiries about particular transactions. Several issuers suggested including costs of processing chargebacks, other than the costs proposed (e.g., data processing and sending the message), such as the costs of resolving cardholder inquiries to determine whether the issuer has a chargeback right. One consumer group encouraged including the cost of processing chargebacks in allowable costs in order to encourage issuers to use

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[124] The Board's survey data included the costs of loading funds to prepaid cards as part of reported processing costs. The Board does not believe these costs should be considered in establishing the interchange fee standard because they are not specific to a particular electronic debit transaction and are more akin to deposit account costs, which have not been included in setting the debit interchange fee standard. However, these costs could not be separated from other processing costs that should be included. Because reloadable prepaid cards transactions are a very small proportion of total electronic debit transactions, the Board believes this inclusion is immaterial and does not affect the calculation of the overall cap amount. Future surveys will ask that this cost not be included in reporting processing costs for reloadable prepaid costs.

[125] The circumstances under which an issuer may reverse a transaction vary based on network rules and include an error in the transaction information, duplicate processing, an unauthorized transaction, and non-receipt of merchandise.

networks that provide chargeback rights to consumers.[126] A few merchants opposed including the costs of fraud-related chargebacks, arguing such costs should be included as part of the fraud-prevention adjustment, if at all.

Chargebacks and other non-routine transactions are separate transactions that essentially unwind the initial transaction (see discussion of the definition of "electronic debit transaction," § 235.2(h)). The associated costs of processing these transactions are "specific to a particular transaction." The final rule considers the costs of processing chargebacks and other non-routine transactions as a basis for establishing the standard for interchange fees. As implied by the discussion in a companion interim final rule, published separately in the *Federal Register*, the costs of processing chargebacks are not considered for purposes of the fraud-prevention adjustment; therefore, including the issuer's cost of processing fraud-related chargebacks in the interchange fee standard will not result in double-recovery.

*Network processing fees*. The Board received numerous comments on the proposed exclusion of network processing fees (e.g., switch fees) as a type of allowable cost. Many issuers and networks requested that the Board include network processing fees because such fees are directly related to the authorization, clearance, and settlement of a transaction. One network asserted that excluding network processing fees created an inconsistency if per-transaction fees paid to third parties could be included as allowable costs. Merchants, by contrast, overwhelmingly supported the exclusion of network processing fees because, if such fees were included, merchants would be in the position of paying all network fees for a transaction. One issuer contended that if network processing fees were excluded, issuers should be permitted to receive net compensation from the networks so that issuers could realize the value to the

[126] That commenter suggested that, under proposed Alternative 1, the Board should allow issuers to recover costs where the merchant has gone out of business, and under proposed Alternative 2, the Board should reduce the cap to 11 cents and allow issuers to recover 1 cent for maintaining an effective debit card chargeback program.

networks of their cardholder base. This is discussed further in the section related to circumvention and evasion.

The Board believes that network processing fees are both specific to a particular transaction and incurred for the issuer's role in authorization, clearance, and settlement. Network processing fees are incurred by issuers in the course of effecting electronic debit transactions, and the total amount of fees charged to an issuer is determined by the amount of electronic debit transactions processed for that issuer. The Board has included network processing fees in determining the standard for interchange fees. Merchant-routing choice may place downward pressure over time on the level of network fees assessed to acquirers. To the extent that acquirers and merchants may be in the position of directly paying all of their network fees as well as paying the network fees of covered issuers through interchange fees, such an arrangement would be similar to traditional paper-check processing where the payee's bank (the corollary to the acquirer for the merchant) typically pays all of the processing costs, while the payor's bank (the corollary of the issuer in an electronic debit transaction) typically pays no processing fees. The Board recognizes, however, that in electronic check collection systems, both the payee's bank and the payor's bank generally pay processing fees.

*Transactions monitoring.* The proposal excluded authorization-related fraud-prevention costs from allowable costs in proposed § 235.3. Numerous commenters (predominantly issuers) recommended including costs of such fraud-prevention activities in the interchange fee standard because the pre-authorization fraud-prevention activities are integral to transaction authorization. These commenters suggested that such costs could include the cost of enrolling in or maintaining programs that monitor transactions prior to making the decision to authorize the transaction. Merchants and a few other commenters opposed including fraud-prevention costs in the

interchange fee standard because such costs are intended to be included through the fraud-prevention adjustment.

Transactions monitoring systems assist in the authorization process by providing information to the issuer before the issuer decides to approve or decline the transaction. Issuers may monitor transactions through the use of neural networks and fraud-risk scoring systems. Transactions monitoring is as integral to the authorization decision as confirming that a card is valid and authenticating the cardholder. For example, an issuer may flag a transaction as suspicious and decline the authorization request or require the merchant to verify the transaction with the issuer before deciding whether to approve or deny the transaction.

In comparison, the types of fraud-prevention activities considered in connection with the fraud-prevention adjustment (discussed in an interim final rule published separately in the *Federal Register*) are those activities that prevent fraud with respect to transactions at times other than when the issuer is effecting the transaction. The issuer's cost of this type of action is not considered a cost of authorization. For example, an issuer may send cardholders alerts after authorizing a transaction or series of transactions to inquire about suspicious activity. These subsequent alerts are intended to prevent future fraudulent transactions and are not a cost of authorizing a particular transaction. Any costs of those subsequent alerts are considered in the fraud-prevention adjustment, but not as a basis for the interchange fee standard. Similarly, the cost of research and development of new authentication methods would be considered in the fraud-prevention adjustment but would not be a cost that is specific to a particular electronic debit transaction and therefore cannot be considered in determining the fee standard.

*Fraud losses.* The proposal did not include fraud losses incurred with respect to electronic debit transactions as an allowable cost. Numerous merchants argued for this exclusion

because they believed that allowing issuers to pass fraud losses on to acquirers or merchants through the interchange fee would largely eliminate the incentive for issuers to take steps to minimize fraud losses, contrary to policy goals of reducing the occurrence of, and losses from, fraudulent electronic debit transactions. On the other hand, numerous issuers and some networks supported including fraud losses as costs that are specific to a particular transaction. These commenters argued that it would be unreasonable for issuers to bear fraud losses without any compensation from merchants because merchants receive benefits from authorized debit card sales (including the payment guarantee) and are in a unique position to prevent fraud losses by checking for cardholder identification or signature, among other things. Moreover, these commenters argued that excluding fraud losses from allowable costs would encourage merchants to ignore possible fraudulent electronic debit transactions. A few issuers also indicated that they incur insurance costs against fraud losses, including paying a per-account deductible.

Two issuers provided general suggestions for measuring the amount of fraud losses that should be included in allowable costs. One issuer suggested that fraud losses be reflected as a variable component in the interchange fee standards because fraud losses increase with transaction size. Another issuer suggested that interchange fees reimburse an issuer for fraud losses based on the issuer's fraud levels vis-à-vis industry fraud levels, but did not elaborate further as to the precise formula to be used.

The Board has considered the comments received on fraud losses. The final rule includes an allowance for fraud losses in determining the interchange fee standard. For purposes of the final rule, fraud losses are those losses incurred by the issuer, other than losses related to

nonsufficient funds, that are not recovered through chargebacks to merchants or debits to or collections from customers.[127]

Fraud losses are costs that are specific to a particular transaction. The issuer's fraud losses are generally the result of the authorization, clearance, and settlement of an apparently valid transaction that the cardholder later identifies as fraudulent. An issuer may experience losses for fraud that it cannot prevent and cannot charge back to the acquirer or recoup from the cardholder.[128] The most common types of fraud reported in the Board's survey were counterfeit card fraud, lost and stolen card fraud, and card-not-present fraud.[129] Certain fraud and the related losses can be reduced through actions by the merchants. Even if the merchant takes all reasonable steps to verify the card user, however, the transaction may nonetheless be fraudulent.

Permitting issuers to recover at least some fraud losses through interchange fees is reasonable given that the source of fraud could be any participant in an electronic debit transaction and that the exact source of fraud often is unknown. Payment card network rules allocate responsibility for fraudulent transactions, but this allocation does not necessarily result in the loss ending up with the party that was in the best position to prevent the fraud. For example, the loss may have occurred from a data breach at a merchant or acquirer not involved in the fraudulent transactions. Additionally, network rules that are vague with respect to merchant requirements for authenticating a signature may lead to fraud losses being borne by the issuer when the merchant was in a position to compare the cardholder's signature with the signature on the back of a card and prevent the fraud.

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[127] The amount of the fraud-prevention adjustment permitted under the accompanying interim final rule published separately in the *Federal Register* does not include consideration of fraud losses. The adjustment amount is based on fraud-prevention costs, rather than fraud losses.

[128] Rules regarding chargeback rights and obligations vary across payment card networks. Some networks have rules that prevent an issuer for imposing any liability on the cardholder for unauthorized transactions.

[129] Counterfeit-card fraud is when a fraudster obtains information about the card and creates a replica of the card.

Allowing a portion of fraud losses to be recovered through interchange fees will not eliminate the incentive for issuers to monitor and prevent fraud. Issuers will continue to bear the cost of some fraud losses and cardholders will continue to demand protection against fraud.

The cost of a fraud loss varies with the amount of the transaction. For example, an issuer takes on a greater risk when approving a $100 transaction than a $5 transaction because the amount of the potential loss is greater. Therefore, fraud losses are best assessed through an *ad valorem* component in the interchange fee standards.

## C. § 235.3 Interchange fee standards

EFTA Section 920(a)(3) requires the Board to establish "standards for assessing" whether the amount of any interchange transaction fee that an issuer receives or charges with respect to an electronic debit transaction is reasonable and proportional to the cost incurred by the issuer with respect to the transaction. The Board proposed that an issuer must comply with its interchange fee standards, under both proposed alternatives, on a per-transaction basis; that is, an issuer could not receive any interchange fee that exceeds its maximum permissible fee. The Board requested comment on two other applications of the interchange fee standards: one that would permit an issuer to comply with the fee standard, on average, for all of its electronic debit transactions, and another that would evaluate compliance at a network level and permit an issuer to comply with the fee standard if, for a particular network, all covered issuers on that network received the amount of the fee standard, on average, for all electronic debit transactions over the network.

### 1. Standards for assessing

A number of issuers argued that a cap on interchange fees was a limit and not a "standard for assessing" whether interchange fees were reasonable and proportional to costs. These commenters argued that Section 920(a) requires more flexible guidelines.

The term "standards" generally means "something established by authority as a rule for the measure of quantity, quality, etc." or the "rule or principle that is used as a basis for judgment."[130] The final rule sets the standard for the maximum permissible interchange transaction fee that may be received by a covered issuer (i.e., a transaction-level standard). If an interchange fee that an issuer receives does not exceed the cap, the amount of the interchange fee is reasonable and proportional to transaction cost. In this way, the cap represents a standard; it is a "rule for the measure of quantity" and "a basis for judgment."

The Board recognizes that providing a standard in the form of general guidelines would provide networks with more flexibility in setting interchange fees. The Board believes, however, that this approach would be extremely difficult to implement and is not required by the statute. Section 920(a) uniquely positions the Board to obtain information regarding each covered issuer's costs and, thus, to consider the transaction costs across all covered issuers in order to determine the point at which interchange fees would no longer be reasonable in light of allowable transaction costs. By contrast, a payment card network does not process transactions for each covered issuer and would receive information from only a subset of covered issuers. Without a uniform numerical standard applicable to all issuers, networks, and transactions (i.e., as adopted in this rule), the definition of the highest reasonable fee could vary across issuers, networks, and transactions. This would make enforcement of the statute extremely difficult and burdensome for all parties and would encourage issuers to choose a network based on the

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[130] *Webster's New World Dictionary and Thesaurus* 17 (2nd ed. 2002); *Random House Webster's Unabridged Dictionary* (2nd ed. 2001).

network's application of the fee standards, rather than based on the services provided by the network.

Setting a uniform standard of the maximum permissible interchange transaction fee that may be received by a covered issuer is also the most practical and least burdensome approach in the context of a complex and dynamic system that handles large and growing volumes of transactions. As many commenters recognized, more general cost-based standards (including proposed Alternative 1) would place a significant burden on industry participants and supervisors.

In addition to meeting the words and purpose of the statute, the final rule's standard provides the proper economic incentives for issuers to improve their efficiency. The final rule provides each issuer an incentive to reduce its per-transaction costs below the level of the cap. The Board will use the data collection authority provided in Section 920(a) to regularly collect data on the costs incurred by issuers in connection with electronic debit transactions and, over time, will adjust the standards based on reported costs, if appropriate. Lower costs should result in a lower interchange fee cap as issuers become more efficient.

**2. Transaction-level standard**

In general, merchants, a few payment card networks, and acquirers (as well as other types of commenters) opposed both an issuer- and network-averaging approach in favor of a transaction-level approach. Merchants contended that averaging would enable the continuation of price discrimination against merchants, and Internet merchants in particular. A few of these commenters stated that averaging was inconsistent with the language of the statute because it permits consideration of non-cost factors in the interchange fee determination. Commenters opposed to averaging also argued that it would impose a substantial administrative burden on

issuers, payment card networks, acquirers, and regulators. Additionally, a few commenters were concerned that averaging likely would result in statutory violations because predicting the transaction mix *ex ante* is exceedingly difficult, and issuers would be unable to control whether they met the target average because merchants would control routing. Another commenter was concerned that, under a network-averaging approach, the largest issuers on a network would receive higher interchange fees than smaller issuers. One issuer suggested that the safe harbor be an average effective rate that approximates current fee levels in order to avoid injecting significant risk into the payment system. This issuer suggested that the Board consider adjusting the safe harbor no sooner than one year after the exclusivity and routing rules go into effect, which should provide the Board time to evaluate whether routing rules are increasing competition.

A few commenters supported an issuer-averaging approach, including one issuer that suggested that the safe harbor be an average of all of an issuer's interchange fees across all networks. One network contended that permitting network averaging was necessary to provide meaningful flexibility in setting interchange fees, would provide incentives for fraud prevention, and would account for cost and risk variation across transactions. One network suggested that network averaging could be combined with a transaction-level upper boundary. The commenters in favor of a network-averaging approach suggested that networks would demonstrate compliance through regular reporting, and any issuers participating in those networks would be deemed to be in compliance. If a network exceeds the standard amount, the commenter suggested that the Board could either permit variation or require corrective actions.

The Board has determined to adopt neither an issuer-averaging nor a network-averaging standard. An issuer-averaging approach, where the only requirement is that an issuer, on

average, receive an interchange fee that does not exceed the cap, would be significantly less burdensome from an enforcement perspective, but would be less likely to produce actual compliance. Issuers and networks would be unlikely to accurately predict an issuer's transaction mix *ex ante* because of fluctuation in cardholders' shopping patterns and merchant routing choice, and therefore may not be able to exactly meet an issuer average. Moreover, such an approach would be less transparent than a transaction-level standard because each party would be unable to determine whether a given interchange fee complied with the standard. Similarly, although a network-averaging approach to the standard would provide networks with more flexibility to vary the amounts of interchange transaction fees by merchant type and transaction type, an individual issuer's compliance would depend on the amounts of interchange transaction fees received by other issuers on the network.

### 3. Determining the interchange fee standard

The Board surveyed institutions expected to be covered by the interchange fee standards to determine their costs relating to debit card programs, among other things. As discussed above, there is no industry standard for cost-accounting systems because institutions use cost-accounting systems predominantly for internal management purposes. In recognition of this, the survey contained instructions regarding the types of costs a responding issuer should report and the types of costs a responding issuer should exclude entirely from its survey responses. Issuers also were asked to provide information on the number of purchase and other electronic debit transactions (such as returns and chargebacks).[131,132]

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[131] In a purchase transaction, value is transferred from the cardholder to the merchant in exchange for goods and services. In a return transaction, the merchant reverses a purchase transaction (due, for example, to the return of goods by the cardholder), and value is transferred from the merchant to the cardholder.

[132] Although the response rates for the surveys were high, some respondents were not able to provide information on all data elements requested in the surveys. For example, most respondents provided cost data at an aggregate level, but some were unable to provide cost data at the level of detail requested in the surveys. In addition, inconsistencies existed in some reported data within individual responses and across responses. Where possible, minor problems

Responding issuers were instructed to exclude corporate overhead costs or any other overhead costs for activities that are not directly related to the issuer's debit card program. If the responding issuer incurred overhead costs directly related to activity in a card program, the issuer could allocate those costs to card program activity. Similarly, if an issuer incurred costs for an activity that was jointly attributable to electronic debit transactions and another program (such as credit cards), the issuer was instructed to allocate the costs of that activity across the programs on a pro rata basis. Issuers were instructed to include the depreciation or amortization of capital expenditures. Throughout the survey instructions, issuers were directed not to include costs that were not tied to debit card programs.

With respect to costs incurred for debit card program activity, the survey requested cost information for the total costs of several activities that were not included as part of authorization, clearance, or settlement: card production and delivery; cardholder inquiries; rewards, incentives, and affinity-partnerships; network membership; research and development; and compliance.[133] Survey respondents were instructed not to include the costs for these activities in any other cost category, which allowed isolation of these cost categories and prevented double-counting of costs. For the reasons stated above, costs for these activities were not considered as the basis for the interchange fee standard.

As discussed in more detail above, the types of costs that form the basis for the interchange fee standard are costs incurred for processing electronic debit transactions,[134] chargebacks, and similar transactions, including network processing fees and transactions monitoring costs; and fraud losses. Each of these categories was reported separately. With

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(e.g., adding components to determine the total or removing minus signs) were resolved, but responses with major problems (e.g., failing to provide critical transaction volume information) were not used.

[133] Issuers were instructed to put information regarding these costs in Section IV of the Card Issuer Survey.

[134] These transactions included purchase and return transactions, authorizations without value transfer, denials, and funds loads to prepaid cards.

respect to transaction processing, issuers were instructed to include the total costs associated with providing authorization for transactions (including data processing, connectivity expenses, voice authorization inquiries, and referral inquiries); clearing and settlement (including receiving, verifying, reconciling, settling transactions with other financial institutions, and posting transactions to cardholder's accounts); and processing chargebacks and other erroneous transactions. Issuers were instructed to separately report network processing fees and their cost for transactions monitoring prior to authorization.[135] Issuers were asked to report costs directly attributable to PIN debit, signature debit, and prepaid card programs.

These data were used to compute an average per-transaction cost for each issuer that reported costs for authorization, clearance and settlement, network fees, and transactions monitoring based on the number of routine purchase transactions.[136] For each such issuer, the total of these costs was computed and divided by the total number of purchase transactions sent to the issuer for authorization during 2009. The data from the Board's survey showed that these average per-transaction costs reported by covered issuers ranged from 3 cents to 66 cents per transaction.[137] The Board used this range as a starting point for setting standards for the base component. Within this range, the Board ranked the average per-transaction allowable cost from the lowest- to highest-cost issuer.

[135] Issuers were instructed to report these costs, except for transactions monitoring, in Section III of the Card Issuer Survey. Issuers were instructed to report all of their fraud-prevention activities and the total costs incurred for each activity in Section V of the Card Issuer Survey. The most commonly reported activity was transactions monitoring.

[136] The number of respondents varies across the cost-categories because not all issuers were able to break out certain cost information. For example, a number of prepaid card issuers reported that they did not know the specific costs associated with their prepaid card program. In some cases those issuers provided more complete data for their signature and PIN programs. In those cases, the issuer's signature and PIN purchase transactions and costs are included, but their prepaid purchase transactions and costs are excluded.

[137] One merchant group stated that the cost estimates in the Board's survey contained an upward bias due to the inclusion of higher-cost prepaid cards (many of which would be excluded). Unlike other debit cards, issuers may not have information on which prepaid cards are exempt because an exemption may be determined by factors in the program manager's or merchant's control (such as whether the card is marketed or labeled as a gift card). Accordingly, the survey did not instruct issuers to differentiate between exempt and non-exempt prepaid cards when reporting data.

The distribution of issuer costs in the survey is quite skewed, with the distribution concentrated in the range of costs below the 80th percentile, and a scattered set of institutions with significantly higher costs above this point. Below the 80th percentile, the difference between the per-transaction allowable costs of adjacently-ranked issuers is small. For example, among issuers whose costs are between the 20th and the 80th percentiles, the largest cost difference over a 5-percentile range of the distribution (e.g., from the 60th to 65th percentile) is about 3 cents. Above the 80th percentile, however, the distribution shows a marked discontinuity, with per-transaction allowable costs varying more significantly across issuers of similar rank. Between the 80th and 85th percentiles, the difference in costs is about 20 cents. The average per-transaction cost of the issuers above the 80th percentile is 49 cents, more than double the level of the cap, and greater than the average interchange fee level recorded in the survey. It appears that some of these higher-cost issuers may face unique circumstances regarding their overall business orientation; for example, some of the issuers with high reported costs appear to be organizations whose commercial banking operations (and associated debit card programs) are small relative to their overall operations. The Board therefore does not believe that setting interchange fee standards to accommodate these higher-cost issuers would be reasonable or proportional to the overall cost experience of the substantial majority of covered issuers. Moreover, the Board does not believe that it is consistent with the statutory purpose to permit networks to set interchange fees in order to accommodate 100 percent of the average per-transaction cost of the highest-cost issuers.

Based on a review of the survey data and public comments, and for the reasons explained above, the final rule establishes a standard that caps the base component of any interchange fee

at 21 cents per transaction, which corresponds to the 80th percentile issuer's average per-transaction included costs.

Fraud losses vary by the value of the transaction and, thus, were considered separately. Issuers were asked to report fraud losses—the total value of fraudulent transactions less any amounts recovered from acquirers, cardholders, or other parties. For issuers that reported net fraud losses, total net fraud losses were divided by the total value of purchase transactions.[138] The Board's survey indicated that the average per-transaction fraud loss, measured in basis points (bps), varied among responding issuers and ranged from 0.86 bps to 19.64 bps.

The Board has determined that it is appropriate to include an allowance for fraud losses in the interchange fee standard, capped at approximately the median of reported issuer fraud losses (5 bps). Using the median figure recognizes that, as explained above, fraud losses can result from the actions or inaction of merchants as well as issuers, and will provide incentives for both issuers and merchants to take appropriate steps to reduce fraud losses, since each group will incur some costs for these losses.

Issuers that incur the included costs at a level below the interchange fee standard cap (the sum of 21 cents and 5 bps multiplied by the value of the transaction) may retain the difference between their costs and the cap. The cap, however, will result in some issuers not fully recovering their average per-transaction cost through interchange fees. Some commenters argued that this result is inconsistent with ratemaking in other contexts in which rates enable regulated entities to recover costs plus a reasonable profit. The Board has considered the comments and, for the reasons explained above, believes that the similarities between the statutes governing rates for public utilities and other regulated entities and Section 920 are limited. In

[138] Issuers were instructed to report information related to fraud losses in Section VI of the Card Issuer Survey. Issuers that reported net fraud losses were not limited to those issuers that reported cost information necessary to calculate the base interchange fee component.

summary, EFTA Section 920(a) does not use the term "just and reasonable" that is typically used in public utility rate-setting statutes.[139] Congress is well aware of this term of art and would have used that phrase had it intended the Board to consider other ratemaking jurisprudence. In addition, public utility rate-setting involves unique circumstances, none of which is present in the case of setting standards for interchange transaction fees. Issuers are unlike public utilities and similarly regulated entities, which typically are required to provide the regulated service to the public or are otherwise restricted from discontinuing provision of the regulated service. In addition, unlike in the case of public utilities and similar entities where the entity's only source of revenue for the service or commodity is the regulated rate, Section 920 regulates only the fees issuers receive from the merchant side of the transaction, not from all sources.[140]

#### 4. Uniform interchange fee standard

Section 235.3(a) applies to all electronic debit transactions not otherwise exempt from the rule, and the maximum permissible interchange fee is the same irrespective of the network over which the transaction is processed, the type of debit card, and the method of cardholder authentication. To determine amounts that would be proportional to cost, the Board considered the average per-transaction allowable costs of issuers for signature-based debit, PIN-based debit, and prepaid card transactions.

##### a. Summary of proposal and comments

Under both proposed alternatives, the maximum permissible interchange fee would be the same irrespective of card type, network, or cardholder authentication method. The Board noted

[139] *See, e.g.*, Natural Gas Act, 15 U.S.C. 717 et seq. *Duquense Light Co. v. Barash*, 488 U.S. 299 (1989).

[140] Several commenters pointed to *Brooks-Scanlon Co. v. R.R. Comm'n of La.*, 251 U.S. 396 (1920), in support of the proposition that the Board should not consider an issuer's ability to receive revenue by charging cardholders fees. The Board believes that there is a material difference between looking to revenue from a separate but commonly-owned business (as was the case in *Brooks-Scanlon*) and looking to revenue from the same service. *See Baltimore & Ohio Railroad v. U.S.*, 345 U.S. 146, 150 (1953).

that issuers reported higher allowable costs for prepaid cards and requested comment on whether it should have separate standards for prepaid card transactions.

Several issuers, networks, merchants, and their trade groups opposed setting different standards (particularly the cap) for PIN-based and signature-based debit card transactions for a variety of reasons, including to avoid any possible discrimination between PIN-based and signature-based networks and to reduce operational complexity. Some of these commenters stated that authentication methods will likely expand beyond PIN and signature and that accounting for all types of authentication methods would further increase operational complexity of standards that differentiate by authentication method. Moreover, interchange fee standards that differentiate by authentication method may impede the introduction of new and innovative authentication methods. Some merchant commenters believed one uniform interchange fee standard would drive the marketplace to PIN-based transactions, which the merchants asserted was "the lowest cost, most secure, and best functioning" method. One merchant commenter contended that having one cap would eliminate circumvention and evasion concerns.

Other commenters supported having different standards for PIN-based and signature-based transactions because of different risks and costs associated with each type of transaction. These commenters contended that having one cap would decrease incentives for merchants to use, or become enabled to use, PIN-based transactions (especially in light of the expense of PIN pads). Additionally, some commenters believed a single cap would unfairly affect issuers that process predominantly signature transactions and would result in an issuer recovering a different portion of its costs from year to year depending on its transaction mix.

Several commenters that are active participants in the prepaid industry encouraged the Board to adopt a separate fee standard for prepaid cards in light of the higher costs. Other

commenters suggested the Board allow for variation in interchange fees among different types of prepaid cards, because the costs of authorization, clearance, and settlement vary depending upon the type of prepaid card (e.g., a non-reloadable general-use prepaid card and a health savings account prepaid card).

**b. Analysis of comments and final rule**

Electronic debit transactions are processed over numerous different networks with numerous different pricing structures and participation rules and requirements, and each network's pricing, rules, and requirements vary by type of transaction. Signature networks may have higher switch fees than PIN networks, and within those groups, switch fees vary by network. Similarly, each network may have different rules related to charging back fraudulent transactions, and the rules vary by type of transaction (e.g., card-present and PIN-based). Moreover, new card types and transaction types are developing due to innovation in the payment card industry.

Accordingly, if the standard were to differentiate between signature-based networks and PIN-based networks and were to recognize differentiation across all networks (i.e., a network-specific standard) and transaction types (e.g., card-present and card-not present), the resulting interchange fee standard would require issuers to track their costs (including fraud losses and switch fees) by network and transaction type in order to submit information to the Board. This level of detail would impose larger reporting burden on issuers, as well as a burden on supervisors, to ensure that an issuer was receiving the appropriate interchange fee revenue from each network for each transaction type.

As discussed above, the final rule accounts for variation in the cost incurred by an issuer in effecting an electronic debit transaction by considering the costs of all types of electronic debit

transactions across all issuers responding to the Board's survey. By treating allowable costs that are likely to vary based on network and/or transaction type (e.g., network fees and fraud losses) the same—on an average basis for any given transaction regardless of the network, card type, or transaction type—the final rule avoids providing incentives for issuers to steer consumers to use higher-cost networks, cards, and transaction types.

Several merchants suggested that the same interchange fee standard should apply across merchant types, transaction types, and transaction size, arguing that current variation in interchange fees is due to market power rather than true variation in costs or transaction risks (which, they asserted is accounted for through chargeback rules).[141] By contrast, several issuers suggested that the final rule should allow networks to set interchange fees based on transaction risk. These commenters asserted that fraud losses vary with transaction size, transaction type, and merchant location.

Merchants suggested that the Board establish different standards for small-ticket sales (under $5) because the proposed cap likely would result in higher interchange fees than merchants currently are paying on those transactions. Other merchants thought that variation in transaction risk should be addressed in the fraud-prevention adjustment, if addressed anywhere, and noted that fraud risk exists for both card-present and card-not-present transactions.

For the reasons stated above, the final rule permits an *ad valorem* component such that the total amount of an interchange transaction fee does not exceed the sum of the 21-cent base component and 5 basis points of the transaction value (plus the fraud-prevention adjustment, if applicable). Networks are not prohibited from varying the amount of either interchange fee component by transaction type, transaction value, or merchant type, provided the interchange fee

[141] For example, some merchants stated that card-not-present merchants are experiencing increasingly low rates of fraud (primarily due to the merchants' own investments in fraud prevention), but are subject to higher interchange rates and chargeback rates.

for any transaction not exceed the maximum permissible amounts in § 235.3(b) (plus the fraud-prevention adjustment, if the issuer is eligible to receive the adjustment). *See* comment 3(b)-2. The flexibility to vary the amounts of interchange fee components below the cap enables networks to establish interchange fees that reflect variation in transaction risk and to account for other factors that affect a network's ability to increase its transaction volume.

## IV. § 235.5 Exemptions[142]

The proposed exemptions to the applicability of the interchange fee standard in § 235.5 implement the exemptions set forth in EFTA Section 920(a) for small issuers, government-administered payment programs, and certain reloadable prepaid cards.[143]

Because an electronic debit transaction may qualify for more than one exemption, the Board proposed comment 5-1 to clarify that an issuer need qualify for only one of the exemptions in order to exempt an electronic debit transaction from the interchange provisions in §§ 235.3, 235.4, and 235.6 of the proposed rules. The proposed comment further clarified that a payment card network establishing interchange fees need only satisfy itself that the issuer's transaction qualifies for at least one of the exemptions in order to exempt the electronic debit transaction from the interchange fee restrictions. The Board did not receive any comment on the clarification, and the substance of comment 5-1 has been adopted as proposed with modifications to conform the language of the comment to other revisions.

The Board has adopted new comment 5-2 to provide that payment card networks that plan to allow issuers to receive interchange fees higher than those permitted under §§ 235.3 and 235.4 pursuant to one of the exemptions in § 235.5 must develop their own processes for identifying issuers and products eligible for such exemptions. As discussed in more detail below

[142] The companion interim final rule published separately in the *Federal Register* adds § 235.4 (Fraud-prevention adjustment).
[143] EFTA Section 920(a)(6) and (7).

with respect to each of the exemptions in § 235.5, the Board believes payment card networks are in the best position to develop processes for identifying issuers and products eligible for the various exemptions. However, to assist payment card networks in determining which of the issuers participating in their networks are subject to the rule's interchange fee standards, the Board will publish lists annually of institutions above and below the small issuer exemption asset threshold.

**A. § 235.5(a) Exemption for small issuers**

EFTA Section 920(a)(6)(A) provides an exemption from EFTA Section 920(a) for any issuer that, together with its affiliates, has assets of less than $10 billion. EFTA Section 920(a)(6)(B) limits the term "issuer" for purposes of this exemption to the person holding the asset account that is debited through an electronic debit transaction.[144]

Proposed § 235.5(a) implemented EFTA Sections 920(a)(6)(A) and (B) by providing that §§ 235.3, 235.4, and 235.6 do not apply to an interchange transaction fee received or charged by an issuer with respect to an electronic debit transaction if (i) the issuer holds the account that is debited; and (ii) the issuer, together with its affiliates, has assets of less than $10 billion as of the end of the previous calendar year. Proposed comment 5(a)-1 clarified that an issuer would qualify for this exemption if its total worldwide banking and nonbanking assets, including assets of affiliates, are less than $10 billion. Furthermore, consistent with other Board rules, the Board proposed to designate the end of the calendar year to measure the assets of an issuer and its affiliates.[145]

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[144] EFTA Section 920(a)(6)(B). The Board noted in its supplementary information to its proposed rule that an issuer of decoupled debit cards, which is not the institution holding the consumer's asset account from which funds are debited when the card is used, would not qualify for the exemption under EFTA Section 920(a)(6)(A) given the definition of "issuer" under EFTA Section 920(a)(6)(B), regardless of the issuer's asset size.

[145] *See, e.g.*, 12 CFR § 203.2(e)(1)(i) and 12 CFR § 228.20(u).

The Board received numerous comments from a variety of commenters, including large and small issuers, merchants, consumer groups, members of Congress, and other financial institution regulatory agencies expressing concern that the small issuer exemption would not be effective in practice.[146] Many issuer commenters stated that they did not believe that payment card networks would implement two-tier fee structures (i.e., different fee structures for covered issuers and exempt issuers). Other issuer commenters stated that although networks may attempt to implement two-tier fee structures, market forces and merchant routing choice will erode the differences between the two fee structures until there is only one interchange fee that all issuers may charge or very little variation between the two fees. Some of these commenters expressed concern that if small issuers were required to accept the same interchange fees as covered issuers, small issuers' debit card programs might not be sustainable and that these issuers could be forced to severely limit or abolish these programs.

Many issuer commenters also requested that the Board mandate that payment card networks implement two-tier fee structures. Several issuer commenters stated that even if payment card networks were to institute two-tier fee structures, they believe merchants would pressure customers or steer customers through discounts to use another form of payment or refuse exempt cards or cards issued by exempt issuers.

By contrast, merchant commenters also noted that they believe networks have an incentive to institute two-tier fee structures to attract and retain the business of exempt issuers and issuers of exempt products. In addition, merchant commenters, some consumer group commenters, and a member of Congress stated that they do not believe merchants would risk

[146] Although these comments focused on the effectiveness of the small issuer exemption, the other exemptions (i.e., debit cards issued pursuant to certain government payment programs and certain general-use prepaid cards) raise similar concerns.

alienating customers by refusing to accept certain cards or discriminating against the use of certain cards through, for example, the use of differential pricing.

The Board's final rule provides exemptions from the interchange fee standards in accordance with EFTA Sections 920(a)(6) and (7). The EFTA does not provide the Board with specific authority to require networks to implement these exemptions in any particular way. The Board notes, however, that payment card networks that collectively process more than 80 percent of debit card volume have indicated that they plan to implement two-tier fee structures.

The Board is taking several steps, including using the data collection authority provided in EFTA Section 920(a)(3)(B), to allow the Board to monitor and report to Congress on the effectiveness of the exemption for small issuers. First, the Board plans to publish annually lists of institutions above and below the small issuer exemption asset threshold to assist payment card networks in determining which of the issuers participating in their networks are subject to the rule's interchange fee standards.[147] Second, the Board plans to survey payment card networks annually and publish annually a list of the average interchange fees each network provides to its covered issuers and to its exempt issuers. This list should enable issuers, including small issuers, and Congress to more readily understand whether the provisions of EFTA Section 920 and the implementing rule, including the small issuer exemption, are having a meaningful effect.

With respect to comments on discrimination by merchants, Section 920(b)(2) prohibits payment card networks from inhibiting the ability of any person to provide a discount or in-kind incentive for payment by the use of debit cards to the extent that the discount or in-kind incentive does not differentiate on the basis of the issuer or the payment card network. Section 920(b)(4)(A) further provides that no provision of Section 920(b) shall be construed to authorize

[147] The lists will be posted on the Board's public website.

any person to discriminate between debit cards within a payment card network on the basis of the issuer of the debit card.

Moreover, the Board understands that many payment card networks have rules that require merchants to accept all cards of that payment product type within that network, regardless of issuer. Merchants also would likely face negative consequences by refusing to accept a particular issuer's debit card. Unlike credit cards, where customers may have cards from more than one issuer, customers are more likely to have only one debit card. A merchant refusing a customer's particular debit card could cause the customer to use a credit card, a potentially more expensive form of payment for the merchant. Alternatively, the merchant may lose the sale if the customer does not have enough cash or another payment method that would be acceptable to the merchant.

The Board also received several other comments on this exemption. Some issuer commenters and a financial regulatory agency urged the Board to extend the exemption for small issuers to the network exclusivity and routing provisions of § 235.7. Although EFTA Section 920(a)(6) provides that small issuers are exempt from the provisions of EFTA Section 920(a) concerning the interchange fee standards, the statute does not extend the exemption to the network exclusivity and routing provisions of EFTA Section 920(b). Some commenters urged the Board to use the exception authority under EFTA Section 904(c) to extend the exemption. The Dodd Frank Act removes this authority from the Board as of July 21, 2011, however.

A payment card network suggested that in assessing whether an issuer qualifies for the exemption in § 235.5(a), only U.S. assets should be considered. EFTA Section 920(a)(6) does not specify that the exemption should be based on U.S. assets only and nothing in the purpose or structure of EFTA Section 920 or in practical operation indicates that the provision should not

apply to issuers with large foreign operations that also operate in the U.S. Indeed, applying the statute to apply to worldwide assets would be consistent with the principle of national treatment of foreign firms operating in the U.S. Therefore, the Board believes that this measurement should be based on worldwide assets.

The final rule also clarifies whether trust assets should be considered in determining whether an issuer's assets fall below the $10 billion exemption threshold. Trust assets under management are not considered assets of the issuer or its affiliates, and are not reflected on the issuer's or affiliate's balance sheet. Therefore, comment 5(a)-1 states that an issuer qualifies for the small issuer exemption if its total worldwide banking and nonbanking assets, including assets of affiliates, other than trust assets under management, are less than $10 billion.

In the supplementary information to its proposed rule, the Board noted that to the extent payment card networks plan to permit issuers meeting the small issuer exemption to receive higher interchange fees than allowed under §§ 235.3 and 235.4, such networks should establish a process to identify small issuers and to provide information to acquirers and merchant processors to enable them to determine what interchange fee applies to each issuer. The Board requested comment on whether the rule should establish a certification process and reporting period for an issuer to notify a payment card network and other parties that the issuer qualifies for the small issuer exemption.

Payment card network commenters suggested that a Board-developed process would ensure that there is consistent treatment across the industry and requested that the Board annually publish a list of exempt and non-exempt issuers based on asset size. A merchant trade group and several processors suggested that the Board develop a certification process for small issuers to notify the Board and the payment card networks within 90 days of the end of the preceding

calendar year that they qualify for the exemption. A merchant trade group commenter also expressed concerns with networks solely managing the exemption process. Another processor commenter suggested that the payment card networks should manage the certification process but that the Board should establish the reporting period for consistency.

The Board plans to publish annually lists of institutions above and below the small issuer exemption asset threshold and those for which the Board is unable to make a determination, due to incomplete or unreliable affiliate data.[148] There may exist a small number of debit-card issuers that do not appear on any of these lists.[149] The Board will compile these lists based on data in the Board's possession.[150] These lists, based on assets as of December 31, 2010, will be posted on the Board's website. The Board has redesignated proposed § 235.5(a) as § 235.5(a)(1) and adopting § 235.5(a)(2) to provide that a person may rely on these Board-published lists to determine whether an issuer, together with its affiliates, has assets of less than $10 billion as of the end of a calendar year. To the extent that an issuer qualifies for the small issuer exemption but is not included on the Board's list of exempt institutions, payment card networks may institute their own processes for such issuers to certify their eligibility for the exemption to the networks. *See* comment 5-2.

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[148] The Board has insufficient data to determine whether every issuer, together with its affiliates, has assets above or below $10 billion; e.g., the Board may not have data on affiliates of industrial loan companies with assets below $10 billion.

[149] The lists, for example, would not include depository institutions without regulatory financial data reported as of the report date, depository institutions without federal insurance, and issuers that are not depository institutions.

[150] The Board's sources of data to compile these lists include: the Consolidated Financial Statements for Bank Holding Companies (FR Y-9C; OMB No. 7100-0128), the Consolidated Reports of Condition and Income (Call Reports) for independent commercial banks (FFIEC 031 & 041; OMB No. 7100-0036), the Consolidated Reports on Condition and Income (Call Reports) for Edge and agreement corporations (FR 2886b; OMB No. 7100-0086), the Reports of Assets and Liabilities of and for U.S. branches and agencies of foreign banks (FFIEC 002; OMB No. 7100-0032), the Thrift Financial Reports (OTS 1313; OMB No. 1550-0023) for thrift holding companies and thrift institutions, the Credit Union Reports of Condition and Income (NCUA 5300/5300S; OMB No. 3133-0004) for credit unions, and the Corporate Credit Union Monthly Call Report (NCUA 5310; OMB No. 3133-0067) for corporate credit unions.

From year to year, issuers that are exempt may become covered issuers based on changes in assets and affiliates. The Board has added § 235.5(a)(3) (and comment 5(a)-2) to provide that, if an issuer no longer qualifies for the small issuer exemption as of the end of a calendar year because at that time it, together with its affiliates, has assets of $10 billion or more, the newly covered issuer must begin complying with the interchange fee standards (§ 235.3), the fraud-prevention standards (§ 235.4) (to the extent the issuer wishes to receive a fraud-prevention adjustment), and the provisions prohibiting circumvention, evasion, and net compensation (§ 235.6) no later than July 1 of the following year. This date provides time for issuers and networks to determine the applicability of the exemption and implement any necessary system updates to enable compliance.

**B. § 235.5(b) Exemption for government-administered programs**

EFTA Section 920(a)(7)(A)(i) provides an exemption for an interchange transaction fee charged or received with respect to an electronic debit transaction made using a debit or general-use prepaid card that has been provided to a person pursuant to a Federal, State, or local government-administered payment program, in which the person may use the debit or general-use prepaid card only to transfer or debit funds, monetary value, or other assets that have been provided pursuant to such program. The Board proposed to implement this provision in § 235.5(b) with minor non-substantive changes to the statutory language.[151] A merchant trade group commenter suggested that the exemption for government-administered payment programs should be temporary. The statute does not place an expiration date for the exemption unless certain limited conditions are met. The final rule follows the statute.

[151]As the Board discussed in its proposed rule, Section 1075(b) of the Dodd-Frank Act amends the Food and Nutrition Act of 2008, the Farm Security and Rural Investment Act of 2002, and the Child Nutrition of 1966 to clarify that the electronic benefit transfer or reimbursement systems established under these acts are not subject to EFTA Section 920. These amendments are consistent with, and covered by, the exemption under EFTA Section 920(a)(7)(i).

Issuer commenters asked the Board to expand the exemption for government-administered payment programs to the network exclusivity provisions in § 235.7. Although the statute exempts government-administered payment programs from the interchange fee standards, it does not provide an exemption from the network exclusivity provisions for these programs, or specific authority for the Board to grant an exemption from these provisions. Thus, the Board has not exempted government-administered payment programs from the provisions of § 235.7.

Commenters requested that the Board provide further clarification on application of the exemption for government-administered payment programs. One depository institution trade group suggested that the exemption for government-administered payment programs be extended to "multi-purse" cards where a debit or general-use prepaid card may access funds other than funds provided by a government-administered payment program. The Board believes the statute is clear in stating that the exemption is available for debit or general-use prepaid cards in which a person may use such card *only* to transfer or debit funds, monetary, value or other assets that have been provided pursuant to a government-administered payment program. Therefore, the Board has not made the suggested change.

Another commenter requested that the Board clarify that the government-administered payment programs include programs in which funds are paid to a consumer by government agencies, such as jury-duty fees that are funded to a prepaid card, and programs administered by tribal systems. Jury-duty programs administered by Federal, State or local governments, including the courts, appear clearly covered by the exemption in EFTA Section 920(a)(7) to the extent they meet the other requirements of that section. The Board has not attempted to list every type of government program that qualifies for this exemption and has instead retained the general language in the statute.

With respect to programs administered by tribal governments, the Board notes that the statute refers to "Federal, State, or local government-administered programs." Tribal governments do not appear to be either "Federal" or "State" governments. However, unlike other statutes that the Board has implemented by rule,[152] EFTA Section 920 does not limit "local" governments to political subdivisions of Federal or State governments. Therefore, the Board believes that the term "local" government would include a tribal government and that government-administered payment programs would include programs administered by tribal governments. The Board has added a sentence to comment 5(b)-1 to clarify this interpretation.

A merchant trade group commented that it does not believe that HSAs, FSAs, or HRAs are government-administered payment programs. Certain cards that access HSAs, FSAs, and HRAs may qualify for exemptions under § 235.5 depending on how the account is structured. To the extent such accounts are offered in connection with a person's employment and administered by or on behalf of a government employer, the Board believes such accounts may be considered government-administered payment programs. However, a plain reading of the statute indicates that HSAs, FSAs, and HRAs administered for non-governmental entities or individuals by or on behalf of a non-government employer are not "government-administered payment programs," which is the language used by the statute.

The Board proposed comment 5(b)-1 to clarify the meaning of a "government-administered program." The proposed comment provided that a program is considered government-administered regardless of whether a Federal, State, or local government agency operates the program itself or outsources some or all functions to service providers that act on behalf of the government agency. The proposed comment 5(b)-1 also stated that a program may

[152] *See, e.g.*, the Expedited Funds Availability Act (12 U.S.C. 4001(24)) and provisions regarding NOW accounts in 12 U.S.C. 1832(a).

be government administered even if a Federal, State, or local government agency is not the source of funds for the program it administers. The Board did not receive comment on proposed comment 5(b)-1, which is adopted as proposed, with minor non-substantive wording changes for clarity.

The Board also requested comment on whether it should establish a process by which cards that qualify for the government-administered payment program exemption could be identified and information related to such cards relayed to payment card networks. Such a process could assist networks in establishing a two-tier interchange fee structure that allows issuers to receive higher interchange fees than permitted under §§ 235.3 and 235.4 for transactions made using debit cards and general-use prepaid cards issued pursuant to government-administered payment programs. Unlike the process for identifying small issuers that qualify for the exemption in § 235.5(a), commenters were split on whether they thought the Board should develop the process for identifying cards that qualify for the government-administered payment programs exemption. While a Board-established system could provide consistency in the process, the Board acknowledges that identifying and certifying card programs is complex and that the Board may not be in the best position to specify this process. Furthermore, as one payment card network noted, hundreds of new card programs are introduced each year, and Board involvement in the process could delay the timely introduction of these programs. The Board understands that payment card networks generally have a process currently in place to review and approve new card programs, and that determining whether such products would meet the exemption requirements could be built into existing procedures.

For these reasons, the Board believes that payment card networks should have the flexibility to design their own systems for identifying cards that are issued pursuant to a Federal,

State, or local government-administered payment program. Therefore, the final rule does not specify the process for identifying these cards, and as provided in comment 5-2, discussed above, the Board expects that payment card networks will have a process for ensuring that only qualifying card programs take advantage of this exemption.

**C. § 235.5(c) Exemption for certain reloadable prepaid cards**

EFTA Section 920(a)(7)(A)(ii) contains an exemption from the debit interchange fee standards for certain qualifying reloadable, non-gift prepaid cards. The Board proposed to implement the exemption set forth in EFTA Section 920(a)(7)(A)(ii) in § 235.5(c)(1) and in the proposed definition of the term "general-use prepaid card" in § 235.2(i). Specifically, EFTA Section 920(a)(7)(A)(ii) provides an exemption for an interchange transaction fee charged or received with respect to an electronic debit transaction for a plastic card, payment code, or device that is (i) linked to funds, monetary value, or assets purchased or loaded on a prepaid basis; (ii) not issued or approved for use to access or debit any account held by or for the benefit of the cardholder (other than a subaccount or other method of recording or tracking funds purchased or loaded on the card on a prepaid basis); (iii) redeemable at multiple, unaffiliated merchants or service providers, or automated teller machines; (iv) used to transfer or debit funds, monetary value, or other assets; and (v) reloadable and not marketed or labeled as a gift card or gift certificate.

The Board received several comments regarding this exemption. Commenters expressed concern that issuers may try to restructure accounts in order to qualify for the exemption under EFTA Section 920(a)(7)(A)(ii). One merchant trade group suggested that the Board limit the exemption to cards that are reloadable by means other than ACH transfer or a check drawn upon an asset account. A processor commented that the exemption promotes form-over-substance

manipulation of debit card programs because certain reloadable prepaid cards are virtually identical in function to debit cards. For example, a reloadable card would function nearly in the same manner as a debit card if the funds underlying the card may be accessed by check, ACH, or wire transfer, in addition to by use of the prepaid card.

The Board believes that reloadable cards that provide access to the funds underlying the card through check, ACH, wire transfer or other method (unless these other means of access were used solely for a one-time cash-out of the remaining balance on the card) would not meet the requirement in Section 920(a)(7)(A)(ii)(II) that the card *not* be issued or approved for use to access or debit any account held by or for the benefit of the cardholder (other than certain sub-accounts). If funds underlying the card may be accessed by the customer using alternate payment methods, the customer would have access to an account held by the customer or for the customer’s benefit.

The Board has added new § 235.5(c)(1)(iii) to clarify that the exemption for a general-use prepaid card applies only if the card is the only means to access the funds underlying the card, except when all remaining funds are provided to the cardholder in a single transaction. Thus, transactions using prepaid cards that provide regular access to funds underlying the card through check or ACH would be subject to the interchange fee restrictions.

Comment 6(a)-2 provides examples of activities that may warrant additional supervisory scrutiny to determine whether there has been circumvention or evasion of the interchange fee standard. For example, additional supervisory scrutiny may be warranted if an issuer replaces its debit cards with prepaid cards that are linked to its customers’ transaction accounts and funds swept from the transaction accounts to the prepaid accounts as needed to cover transactions made.

The Board also received many comments on the interpretation of the condition that the exemption in proposed § 235.5(c)(1) is available only if a card is not issued or approved for use to access or debit any account held by or for the benefit of the cardholder (other than a subaccount or other method of recording or tracking funds purchased or loaded on the card on a prepaid basis). An issuer and a merchant group noted that FDIC pass-through insurance is only available for omnibus accounts for which the individual participants can be identified by the accountholder. Based on this observation, a merchant group stated that if funds are accorded FDIC coverage, then the account is considered to be held "for the benefit of the cardholder," and an electronic debit transaction made using a card that accesses such funds should not be eligible for the exemption under § 235.5(c)(1).

EFTA Section 920(a)(7)(A)(ii) exempts a general-use prepaid card only if it is not issued or approved for use to access or debit any account held by or for the benefit of the cardholder (other than a subaccount or other method of recording or tracking funds purchased or loaded on the card on a prepaid basis). The parenthetical indicates that if the "account held . . . for the benefit of the cardholder" is actually a subaccount or other method of recording or tracking funds purchased or loaded on the card on a prepaid basis, the general-use prepaid card is not considered to access an account held by or for the benefit of the cardholder for purposes of determining whether the general-use prepaid card is exempt. General-use prepaid cards that access funds in an omnibus account that are identifiable to the cardholder by virtue of a subaccount (and thus are eligible for FDIC pass-through insurance) are not considered general-use prepaid cards that are issued or approved for use to access or debit an account held by or for the benefit of the cardholder and thus may still qualify for the exemption in § 235.5(c)(1).

Commenters also requested that the Board make a clearer distinction between account and subaccount. In response, the Board is adopting new comment 5(c)-1 to draw a distinction between an "account" and a "subaccount." Comment 5(c)-1 states that a subaccount is an account within an account, opened in the name of an agent, nominee, or custodian for the benefit of two or more cardholders, where the transactions and balances of individual cardholders are tracked in such subaccounts. An account that is opened solely in the name of a single cardholder is not a subaccount. This clarification is consistent with the way the Board understands subaccounts are structured for most prepaid card programs.

**1. Reloadable and not marketed or labeled as a gift card or gift certificate**

The Board proposed to import commentary related to the meaning of reloadable and not marketed or labeled as a gift card or gift certificate from 12 CFR § 205.20 ("Gift Card Rule"), in which the Board had previously defined and clarified the meaning of "reloadable and not marketed or labeled as a gift card or gift certificate." Specifically, proposed comment 5(c)-1, providing guidance on when a general-use prepaid card is "reloadable," was adapted from comment 20(b)(2)-1 under the Gift Card Rule. Proposed comment 5(c)-2, which was adapted from comment 20(b)(2)-2 under the Gift Card Rule, clarified the meaning of the term "marketed or labeled as a gift card or gift certificate." Proposed comment 5(c)-3 provided examples of what the term "marketed or labeled as a gift card or gift certificate" includes and does not include that are identical to the examples in comment 20(b)(2)-3 under the Gift Card Rule. Proposed comment 5(c)-4, which addressed issues related to maintaining proper policies and procedures to prevent a general-use prepaid card from being marketed as a gift card or gift certificate, was adapted from 20(b)(2)-4 under the Gift Card Rule. Finally, proposed comment

5(c)-5, which provided guidance relating to online sales of gift cards, was substantially the same as comment 20(b)(2)-5 under the Gift Card Rule.

The Board received few comments on proposed comments 5(c)-1 through 5(c)-5. One issuer expressed concerns that the commentary, taken together, is too prescriptive. The Board believes that the detail is necessary to provide issuers with sufficient guidance to determine whether a prepaid card is considered to be reloadable and not marketed or labeled as a gift card or gift certificate. Furthermore, the Board believes it is important to maintain consistency with the Gift Card Rule in interpretation of what is meant by "reloadable and not marketed or labeled as a gift card or gift certificate." Issuers and other parties that are involved in the distribution and sale of prepaid cards are required to make these determinations with respect to the Gift Card Rule, and consistent interpretation across the two rules should reduce confusion and compliance burden.

One merchant group commented that they did not believe HSAs, FSAs, or HRAs qualified for the exemption in § 235.5(c)(1) because they believe that cards accessing HSAs, FSAs, and HRAs are not freely reloadable and may only be reloaded during designated times. The statute does not require that, to qualify for the exemption, a card be reloadable on a continuous basis, only that the card be reloadable and not marketed as a gift card. Accordingly, the final rule has not been changed to require that a card be continuously reloadable to qualify for the exemption for reloadable cards. Therefore, the Board is adopting proposed comment 5(c)-1 as comment 5(c)-2 with minor changes to clarify this point. The Board is adopting proposed comments 5(c)-2 through 5(c)-5 without change as comments 5(c)-3 through 5(c)-6.

### 2. Certification

The Board requested comment on whether it should establish a process to identify accounts accessed by cards eligible for the reloadable prepaid cards exemption or whether it should permit payment card networks to develop their own processes. Comments received on the process for identifying accounts for the reloadable prepaid card exemption were similar to the comments received on the process for identifying accounts for the government-administered payment programs exemption. For the reasons discussed above with respect to the government-administered payment program exemption, the Board believes that the process should be developed and administered by the payment card networks. *See* comment 5-2. Identifying accounts is a complex process that the payment card networks may be better situated to administer. Furthermore, the Board is concerned that a Board-administered process could unnecessarily delay the introduction of new card programs.

### 3. Temporary cards issued in connection with a general-purpose reloadable card

Proposed § 235.5(c)(2) provided that the term "reloadable" includes a temporary non-reloadable card if it is issued solely in connection with a reloadable general-use prepaid card. As the Board discussed in its proposal, this treatment of temporary cards issued in connection with a general-purpose reloadable card is consistent with its treatment under the Gift Card Rule. Proposed comment 5(c)-6, similar to comment 20(b)(2)-6 under the Gift Card Rule, provides additional guidance regarding temporary non-reloadable cards issued solely in connection with a general-purpose reloadable card. The Board did not receive comment on the proposed § 235.5(c)(2), which is adopted as proposed. There were also no comments on proposed comment 5(c)-6, which is adopted as comment 5(c)-7 without change.

### 4. Cards accessing HSAs, FSAs, and HRAs and qualified transportation benefits

Many issuer commenters urged the Board to exempt cards accessing HSAs, FSAs, or HRAs from the interchange fee restrictions as well as the network exclusivity and routing provisions. These commenters also suggested that cards accessing qualified transportation benefits should be exempt. In support of their views, these commenters cited statements from certain members of Congress indicating their belief that cards accessing these types of accounts should be exempt from these provisions.

The statute does not provide an exemption for cards accessing HSAs, FSAs, or HRAs or qualified transportation benefits. Some of these cards may nonetheless fall outside the definitions that establish the scope of coverage of EFTA Section 920. For example, § 235.2(a)(2), which defines "account," does not cover accounts held under a *bona fide* trust agreement. The Board understands that some health-related accounts are established as *bona fide* trust accounts. Therefore, to the extent an account is established as a *bona fide* trust account, electronic debit transactions using a card that accesses such an account would not be covered by the provisions of this part.

For HSAs, FSAs, or HRAs or qualified transportation benefits that are not established as *bona fide* trust accounts, cards accessing such accounts may still meet one of the exemptions under § 235.5 from the interchange fee restrictions, depending on how the account is structured and the issuer of the card. The Board addressed specific comments related to whether electronic debit transactions made using cards that access HSAs, FSAs, and HRAs qualify for the various exemptions from the interchange fee restrictions in the supplementary information to § 235.5(b) and (c) above.

In addition, a number of commenters agreed that issuers face significant complications in complying with the network exclusivity provisions with respect to certain health care and employee benefit cards under current government rules governing these programs. As discussed further in the supplementary information related to § 235.7(c)(3) and comment 7(c)-1, the Board is providing a delayed effective date for electronic debit transactions using debit cards that use point-of-sale transaction qualification or substantiation systems for verifying the eligibility of purchased goods or services to provide issuers of such cards additional time to identify and implement approaches to comply with the rule's network exclusivity provisions.

**D. §235.5(d) Exception**

EFTA Section 920(a)(7)(B) provides that the exemptions available under EFTA Sections 920(a)(7)(A)(i) and (ii) terminate after the end of the one-year period beginning on the effective date of the statute if either of the following fees may be charged: a fee for an overdraft, including a shortage a shortage of funds or a transaction processed for an amount exceeding the balance; or a fee imposed by the issuer for the first withdrawal per month from an ATM that is part of the issuer's designated ATM network. Proposed § 235.5(d) implemented this section by providing that the exemptions in §§ 235.5(b) and (c) are not available for any interchange transaction fee received or charged by an issuer on or after July 21, 2012, with respect to an electronic debit transaction, if any of the following fees may be charged to a cardholder with respect to the card: (i) a fee or charge for an overdraft, including a shortage of funds or a transaction processed for an amount exceeding the account balance, unless the fee or charge is imposed for transferring funds from another asset account to cover a shortfall in the account accessed by the card; or (ii) a fee imposed by the issuer for the first withdrawal per calendar month from an automated teller machine that is part of the issuer's designated automated teller

machine network.[153] The Board's proposal clarified that the fee described in § 235.5(d)(1) does not include a fee or charge imposed for transferring funds from another asset account to cover a shortfall in the account accessed by the card. Such a fee is not an "overdraft" fee because the cardholder has a means of covering a shortfall in the account connected to the card with funds transferred from another asset account, and the fee is charged for making such a transfer. The Board has determined to adopt § 235.5(d) as proposed, but is making some revisions to the commentary as discussed below.

Several industry commenters suggested the Board clarify the proposed exception. One prepaid card processor requested that the Board make clear that an issuer with its own proprietary ATM network, which identifies the issuer's name and does not charge a fee for the first ATM withdrawal in a calendar month, does not lose the exemption because the cards it issues also have access to a nonproprietary ATM network that charges fees. Proposed § 235.5(d)(2) provides that the exemptions are not available if a fee is imposed by the issuer for the first withdrawal per calendar month from an ATM that is part of the issuer's designated ATM network. Therefore, a fee may be charged for a withdrawal from an ATM *outside* of the issuer's designated ATM network without the issuer losing the exemption. The Board has adopted comment 5(d)-1 to clarify this point by providing that an electronic debit card transaction may still qualify for the exemption under §§ 235.5(b) or (c) with a respect to a card for which a fee may be imposed for a withdrawal from an ATM that is outside of the issuer's designated ATM network as long as the card complies with the condition set forth in § 235.5(d)(2) for withdrawals within the issuer's designated ATM network.

An issuer requested that the Board clarify that the condition in § 235.5(d)(2) regarding ATM fees would not apply to cards that do not have ATM access. A card that does not have

[153] Section 235.2(g) defines the term "designated automated teller machine (ATM) network."

ATM access will not be subject to any fees for withdrawals from an ATM; therefore, such a card would not lose the exemption on the basis of § 235.5(d)(2). The Board has added a sentence to comment 5(d)-1 to clarify this point.

The Board also received a comment from a prepaid card processor suggesting that the Board provide alternatives for issuers without their own proprietary ATM network to meet the condition set forth in § 235.5(d)(2) by entering into an arrangement with either (i) a nonproprietary network where a fee will not be charged for the first ATM withdrawal in a calendar month; or (ii) a local bank, bank agent, or retail seller to allow for in-branch or in-store free cash withdrawal per calendar month using the card, regardless of whether any ATMs are available for use. With respect to the first suggested alternative, the Board notes that an issuer's "designated ATM network" is defined in § 235.2(g) as including either a network in the name of the issuer *or* any network of ATMs identified by the issuer that provides reasonable and convenient access to the issuer's customers. As a result, the definition already contemplates the possibility of an issuer entering into an arrangement with a nonproprietary ATM network. With respect to the second suggested alternative, tellers, bank agents, and point-of-sale terminals are not considered ATMs and cannot comprise an ATM network. If the card can be used to access ATMs with an issuer's designated ATM network, then in order for the card to qualify for the general-use prepaid exemption after July 21, 2012, a fee cannot be imposed by the issuer for the first withdrawal per calendar month from an ATM that is part of the issuer's designated ATM network, irrespective of whether a cardholder can obtain fee-free cash withdrawals from a branch or a retail store.

A prepaid card trade group suggested that the Board permit issuers to meet the condition in § 235.5(d)(2) by providing a credit to the cardholder within the month that a fee for

withdrawal from an ATM is imposed. Although a cardholder in this scenario would be reimbursed the fee, and thus have a fee-free ATM withdrawal, there may be other negative consequences to the cardholder that would not occur if the fee for the ATM withdrawal had not initially been imposed. For example, the imposition of such a fee could cause a subsequent transaction to be declined or returned. The fact that the fee is later reimbursed does not reverse the negative consequence of the fee being imposed in the first place. Therefore, the final rule does not permit issuers to meet the condition in § 235.5(d)(2) by imposing the fee and providing a subsequent credit.

Finally, consumer groups were supportive of the conditions in § 235.5(d) and thought the conditions provided important consumer protections. However, they believed the Board should require additional protections, including extending the other provisions of Regulation E, such as error resolution and periodic statement requirements, to general-use prepaid cards, and preventing any form of credit that automatically triggers repayment of funds deposited on a general-use prepaid card. The Board believes that these suggestions fall outside the scope of this rulemaking and will not address these issues in this final rule.

**V. § 235.6 Prohibition on circumvention or evasion**

EFTA Section 920 contains two separate grants of authority to the Board to address circumvention or evasion of the restrictions on interchange transaction fees. First, EFTA Section 920(a)(1) provides the Board with general authority to prescribe rules to prevent circumvention or evasion of the interchange fee standards under EFTA Section 920(a). In addition, EFTA Section 920(a)(8) authorizes the Board to prescribe rules regarding any network fees, but such authority is limited to regulations to ensure that a network fee (i) "is not used to directly or indirectly compensate an issuer with respect to" an electronic debit transaction; and (ii) "is not

used to circumvent or evade" the interchange transaction fee restrictions under EFTA Section 920(a) and this rule.[154] Under EFTA Section 920(a)(8)(B), using a network fee to directly or indirectly compensate an issuer with respect to an electronic debit transaction is a separate prohibition from using a network fee to circumvent or evade the interchange fee standards. The proposed rule contained a general prohibition against circumventing or evading the interchange transaction fee restrictions, as well as a statement that circumvention or evasion occurs if an issuer receives net compensation from a payment card network with respect to electronic debit transactions.

The final rule adopts the proposed rule's general prohibition of circumvention or evasion. Comment 6(a)-1 clarifies that the determination of circumvention or evasion will be based on the particular facts and circumstances. The final rule also prohibits an issuer from receiving net compensation from a payment card network, excluding interchange transaction fees received from acquirers. The commentary to the final rule includes examples of situations that do not involve net compensation, but may nevertheless warrant additional supervisory scrutiny to determine whether circumvention or evasion exists. Finally, the final rule clarifies the time period over which net compensation will be measured.

**A. Overview of network fees, discounts, and incentives**

Payment card networks charge network participants a variety of fees in connection with electronic debit transactions. On the issuer side, fees charged by the network include access fees for connectivity and fees for authorizing, clearing, and settling debit card transactions through the network (i.e., switch fees). Issuers also pay fees to the network for the costs of administering the network, such as service fees for supporting the network infrastructure, and membership and

[154] Under EFTA Section 920(a)(1), a network fee is defined as "any fee charged and received by a payment card network with respect to an electronic debit transaction, other than an interchange transaction fee."

licensing fees. In addition, a network may charge fees to issuers for optional services, such as for transaction routing and processing services provided by the network or its affiliates or for fraud detection and risk mitigation services.

On the acquirer and merchant side, a network similarly charges fees for accessing the network, as well as fees for authorizing, clearing, and settling debit card transactions through the network. Likewise, networks charge network administration fees, membership or merchant acceptance fees, and licensing or member registration fees to acquirers and/or merchants. There are also fees for various optional services offered by the network to acquirers or merchants, including fees for fraud detection and risk mitigation services.

A fee charged by the network can be assessed as a flat fee or on a per-transaction basis, and may also vary based on transaction size, transaction type, or other network-established criteria. Issuers and merchants may be given individualized discounts by a network relative to its published network fee based on their transaction volume.

In addition to discounts, issuers and merchants may receive incentive payments or rebates from a network. These incentives may include upfront payments to encourage issuers to shift some or all of their debit card volume to the network, such as signing bonuses upon contract execution. Such payments may help issuers defray the conversion cost of issuing new cards or of marketing the network brand. In addition, issuers may receive incentive payments upon reaching or exceeding debit card transaction, percentage share, or dollar volume threshold amounts.

Discounts and incentives enable networks to compete for business from issuers and merchants. Among other things, these pricing tools help networks attract new issuers and retain existing issuers, as well as expand merchant acceptance to increase the attractiveness of the

network brand. Discounts and incentives also help networks to encourage specific processing behavior, such as the use of enhanced authorization methods or the deployment of additional merchant terminals.

**B. § 235.6(a) Prohibition of circumvention or evasion**

A payment card network may consider a number of factors in calibrating the appropriate level of network fees, discounts, and incentives in order to achieve network objectives. EFTA Section 920(a) does not directly regulate the fees that a network may charge for any of its services. Thus, the final rule does not seek to set or establish the amount, type, or level of network fees that a network may permissibly impose on any network participant for its services. However, the statute authorizes the Board to prescribe rules to prevent circumvention or evasion of the interchange transaction fee standards. This authority is both general with respect to the Board's implementation of the interchange transaction fee standards under EFTA Section 920(a)(1), as well as specific with respect to the use of network fees under EFTA Section 920(a)(8)(B)(ii).

Under the proposed rule, § 235.6(a) set out a general prohibition against circumventing or evading the interchange transaction fee standards in §§ 235.3 and 235.4. In addition, proposed § 235.6 expressly prohibited, as an example of circumvention or evasion of the interchange transaction fee standards, an issuer from receiving net compensation from a payment card network with respect to electronic debit transactions because such compensation could effectively serve as a transfer to issuers that may be in excess of the amount of interchange transaction fee revenue allowed under the standards in §§ 235.3 and 235.4.

Proposed comment 6-1 further clarified that any finding of circumvention or evasion of the interchange transaction fee standards will depend on the relevant facts or circumstances.

Proposed comment 6-1.i. provided an example of net compensation occurring in violation of the prohibition on circumvention or evasion when an issuer receives payments or incentives in connection with electronic debit transactions that exceed the total amount of fees paid by the issuer to the network for such transactions. The proposed comment also included examples of payments or incentives and fees that would be included in the net compensation determination, as well as those that would not be included. Among the payments or incentives that would be considered in the net compensation analysis were payments or rebates to issuers for meeting or exceeding certain transaction volume or dollar amount thresholds, as well as marketing incentives and other fixed payments for "debit card activities."

Issuers and depository institution trade associations generally commented that the proposed rule appropriately limited the scope of the net compensation analysis to payments made "with respect to electronic debit transactions." However, these commenters further stated that the proposed commentary interpreting the rule exceeded the scope of the statutory prohibition on circumvention or evasion in EFTA Section 920(a)(8) by also considering payments for "debit card-related activities." In the view of these commenters, the only payments that should be considered in the net compensation analysis are payments to an issuer for its role in an electronic debit transaction, or more precisely, payments that vary with the number or volume of debit card transactions processed on the network. Accordingly, issuers asserted that payments made by networks to issuers for other debit card-related purposes, such as for marketing or to encourage investment in network infrastructure, should be excluded from the net compensation analysis. Several issuer commenters further expressed the view that inclusion of payments that were not tied to debit card volume would unnecessarily inhibit a network's ability to attract issuers,

promote investment in the network, or provide incentives for desirable issuer behavior, such as enhancing data security procedures.

Merchant commenters and a member of Congress stated that the proposed rule was overly narrow in scope in limiting circumvention or evasion to circumstances in which an issuer receives net compensation from a network in connection with electronic debit transactions. These commenters urged the Board to clarify that net compensation is not the exclusive test for circumvention by, for example, including general anti-circumvention language in the rule. According to merchant commenters, such general anti-circumvention language would address attempts by networks and issuers to adjust their pricing policies or restructure their products to avoid being subject to the standards set forth in the rule. Merchants also recommended that the Board specifically include an enforcement mechanism to address occurrences of circumvention or evasion.

The final rule adopts the general prohibition on circumvention or evasion of the interchange transaction fee standards in §§ 235.3 and 235.4, substantially as proposed. Comment 6-1, as in proposed comment 6-3, clarifies that the prohibition in § 235.6 against circumventing or evading the interchange transaction fee standards does not apply to issuers or products that qualify for an exemption under § 235.5. Thus, for example, § 235.6 does not apply to an issuer with consolidated assets below $10 billion holding the account that is debited in an electronic debit transaction. The final rule adopts the comment as proposed, redesignated as comment 6-1.

Comment 6(a)-1 is modified from the language in the proposed commentary to state more explicitly that circumvention or evasion may include, but is not limited to, circumstances in which an issuer receives net compensation from a payment card network with respect to

electronic debit transactions or other debit card related activity. Although the proposal established a per se circumstance in which circumvention or evasion of the interchange transaction fee standards occurs (i.e., when an issuer receives net compensation with respect to electronic debit card transactions), the Board did not intend to limit potential findings of circumvention or evasion to such circumstances. Rather, as stated in the supplementary information to the proposed rule, § 235.6 establishes a "*general* prohibition against circumventing or evading the interchange transaction fee standards in §§ 235.3 and 235.4."[155] This concept is made more explicit in the final rule by separating the prohibition against circumvention and evasion and the prohibition against net compensation into different subsections. Comment 6(a)-1 to the final rule retains the provision in the proposed commentary stating that a finding of circumvention or evasion "will depend on all relevant facts and circumstances."

In the proposal, the Board requested comment on whether increases in fees charged by the network to merchants or acquirers coupled with corresponding decreases in fees charged by the network to issuers should also be considered circumvention or evasion of the interchange fee standards in §§ 235.3 and 235.4. For example, following the effective date of this rule, a network might increase network switch fees charged to merchants, acquirers, or processors while decreasing switch fees paid by issuers for the same types of electronic debit transactions. Under these circumstances, the increase in network processing fees charged to merchants is arguably "passed through" to issuers through corresponding decreases in processing fees paid by issuers.

Issuers and payment card networks generally commented that the rule should not address the level of network processing fees regardless of any changes to the proportion of such fees as applied to issuers and merchants. These commenters asserted that EFTA Section 920 is only

[155] *See* 75 FR at 81747 (Dec. 28, 2010) (emphasis added).

intended to address the level of interchange transaction fees and therefore the statute does not regulate the structure or amount of non-interchange fees set by networks, including network processing fees. Merchant commenters, however, stated that decreases in network processing fees charged to issuers and increases in network processing fees charged to merchants or acquirers could easily compensate issuers for reductions in the level of interchange transaction fees in circumvention of the interchange transaction fee standard. Merchants thus urged the Board to cap the level of network fees at current levels until the proposed network exclusivity and routing provisions were fully implemented (in particular, Alternative B) to allow merchants the ability to discipline network fees through their routing choices. Merchants also urged the Board to carefully monitor the networks' operating rules for any changes that shift liability from issuers to merchants as a way to make up for lost income from interchange.

Although the Board recognizes that decreases in issuer fees paid to the network could have the effect of offsetting reductions in interchange transaction fee revenue that will occur under the interchange transaction fee standards in §§ 235.3 and 235.4, the Board continues to believe that such circumstances would not necessarily indicate circumvention or evasion of the interchange transaction fee standards. Moreover, the Board is concerned that an outright prohibition on such shifts in the allocation of network fees would effectively lock in the current distribution of network fees between issuers and merchants, thereby constraining the ability of networks to adjust their own sources of revenue in response to changing market conditions. Such a prohibition may preclude a network from adopting a fee structure similar to that used by a competing network that obtained a larger proportion of its fees from the merchant side of the transaction. Finally, to the extent that networks alter fees for issuers that are incorporated into the interchange fee standard, the permissible interchange fee under the standards will adjust to

reflect those fee changes. Accordingly, the final rule does not treat shifts in the relative proportion of network processing fees paid by issuers and merchants as a per se indication of circumvention or evasion of the interchange transaction fee standards. Instead, as discussed above, individual determinations of circumvention or evasion would depend of the particular facts and circumstances.

New comment 6(a)-2.i thus states that increases in network fees charged to merchants or acquirers and decreases in network fees charged to issuers do not by themselves constitute circumvention or evasion of the interchange transaction fee standards; however, such action may warrant additional supervisory scrutiny to determine whether the facts and circumstances constitute circumvention or evasion.[156] New comment 6(a)-2.ii includes another example based on merchant comments regarding issuers adjusting their products to avoid the final rule's interchange fee limits. The comment describes a situation where an issuer replaces its debit cards with prepaid cards that are exempt from the interchange fee standards of §§ 235.3 and 235.4. The exempt cards are linked to its customers' transaction accounts and funds are swept from the transaction accounts to the prepaid accounts as needed to cover transactions made. Although this situation may not constitute per se circumvention or evasion, it warrants additional supervisory scrutiny to determine whether the facts and circumstances constitute circumvention or evasion.

**B. § 235.6(b) Prohibition of net compensation**

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[156] Merchants also commented that in permitting networks to raise their network fees for merchants or to decrease them for issuers (or both) so long as net compensation is not provided, the Board contradicted its own reasoning for excluding network fees as an allowable cost that can be recovered through the interchange transaction fee standards, that is, to prevent merchants from having to pay all processing fees. As discussed above, however, the final rule permits network processing fees incurred by issuers to be recovered through the interchange transaction fee standards as such costs are incurred to effect an electronic debit card transaction.

The final rule sets out a prohibition against net compensation in § 235.6(b). The description of net compensation contained in proposed comment 6-1.i has been moved to § 235.6(b) of the final rule's regulatory text. As in the proposed comment, an issuer has received net compensation from a payment card network if the total amount of payments or incentives received by the issuer from the payment card network during a calendar year in connection with electronic debit transactions or other debit card-related activity, excluding interchange transaction fees that are passed through to the issuer by the network, exceeds the total of all fees paid by the issuer to the network for electronic debit transactions or other debit card related activity during that calendar year.

The Board notes that the prohibition in EFTA Section 920(a)(8)(B)(i) is not limited to direct compensation to an issuer with respect to electronic debit transactions, but also applies to circumstances in which network fees are used to "indirectly" compensate an issuer with respect to such transactions. Moreover, EFTA Section 920(a)(8)(B)(ii) also includes general authority to ensure that network fees are not used to circumvent or evade the interchange transaction fee standards of the rule. Pursuant to these statutory authorities, the Board believes that the net compensation determination should take into consideration any payments or incentives paid by a network to an issuer for debit card-related activities. In particular, the Board believes that limiting the payments or incentives to payments that are directly related to the number or volume of debit card transactions on the network would potentially create a significant loophole as networks could respond by providing sizable non-volume based incentive payments to an issuer for debit card activities to offset the reduced revenue from the limitations on interchange transaction fees in §§ 235.3 and 235.4. Accordingly, § 235.6(b) in the final rule states that payments and incentives paid to an issuer by a network, and fees paid by an issuer to a network

"with respect to electronic debit transactions or debit card-related activities," are not limited to volume-based or transaction-specific payments, incentives, or fees, but also include other payments, incentives, or fees related to an issuer's provision of debit card services. Such payments could include, for example, bonuses to convert an issuer's card base to a new signature network, or marketing incentives. Comment 6(b)-2 to the final rule provides guidance on the payments or incentives paid by a payment card network that could be considered in determining whether an issuer has received net compensation. Consistent with the proposal, comment 6(b)-2.i states that payments or incentives paid by a payment card network could include, but are not limited to, marketing incentives, payments or rebates for meeting or exceeding a specific transaction volume, percentage share, or dollar amount of transactions processed, or other payments for debit card-related activities.

As noted above, signing bonuses are used as a network tool for encouraging issuers to shift debit card volume to a network, and for maintaining existing card volume on the network. For example, an initial upfront payment from a network may serve to compensate the issuer for its costs in converting its card base to a new signature debit network. Signing bonuses may also offset the issuer's costs in upgrading its internal processing systems and establishing connectivity to the new network. In its proposal, the Board requested comment on whether signing bonuses should also be considered as payments or incentives paid by a network to an issuer for purposes of the net compensation determination.

Issuer commenters generally responded with similar arguments made in connection with the treatment of debit card-related payments unrelated to transaction volume, stating that such bonuses should not be included in the determination because they do not compensate an issuer for the number or volume of transactions processed on a network. One payment card network

expressed concern that including signing bonuses in the net compensation determination could reduce a network's ability to compete with another payment card network that also offered products or services unrelated to their operation of the network at a discount. This network stated that if the final rule curtailed networks' ability to offer signing bonuses by including them in the net compensation calculation, operators of networks that did not offer additional products or services would be left at a competitive disadvantage in their ability to compete for debit card business.

Some issuers observed that initial upfront payments and incentives were likely to exceed the fees charged to the issuer for the first year. For example, a network may provide a new issuer an incentive to participate in the network to offset the issuer's costs to reissue cards, promote the new network brand to cardholders, and establish network connectivity. In this regard, because of the potential size of signing bonuses in relation to fees paid by an issuer on a year-to-year basis, several issuers and one payment card network urged the Board to clarify that signing bonuses would be eligible for pro rata treatment over the term of the contract.

Merchants, two payment card networks, and a processor with an affiliated payment card network, by contrast, believed that signing bonuses should be included in the net compensation determination. Some of these commenters expressed the view that excluding signing bonuses could undermine the entire net compensation approach because networks could create packages with signing bonuses, funded by imposing increased network fee on merchants, without violating the rule.

Comment 6(b)-2.i clarifies that the determination of whether net compensation exists must also take into account signing bonuses paid by a network to an issuer to retain or attract the issuer's debit card portfolio. Just as marketing incentives and other non-volume based payments

for debit card-related activities could be used by a network to compensate an issuer for the issuer's role in electronic debit transactions above and beyond the limits permitted under §§ 235.3 and 235.4, the Board believes that signing bonuses could similarly be used as a mechanism to generate payments to an issuer in excess of the amount permitted under §§ 235.3 and 235.4, absent inclusion in the net compensation calculation. However, as further provided in comment 6(b)-2.ii, the Board agrees that it would be appropriate to allocate such bonuses over the life of the debit card contract in calculating the payments or incentives paid by a network to an issuer. To the extent an issuer receives signing bonuses for its entire card portfolio, including for the issuer's credit card business, an appropriate portion of such bonuses should be allocated to the issuer's debit card business based on the proportion of the cards or transactions that are debit cards or electronic debit transactions, as appropriate to the situation, for purposes of the net compensation determination.

Comment 6(b)-2.iii lists types of payments or incentives that need not be included in the total payments or incentives paid by a network to an issuer for purposes of the net compensation analysis. Among other payments that may be received from a network, issuers may exclude any interchange transaction fees that are passed through to the issuer by the network. The comment also clarifies that incentives paid by a payment card network do not include funds received by an issuer from a payment card network as a result of chargebacks or fines paid by merchants or acquirers for violations of network rules. In response to issuer comments, the commentary also clarifies that settlements or recoveries from merchants or acquirers to offset the costs of fraudulent transactions or a data security breach do not constitute payments or incentives paid by a payment card network.

The proposed commentary also stated that fees paid by an issuer could include fees for optional services provided by the network. *See* proposed comment 6-2.ii. Merchants expressed concern that the proposed approach created a loophole that could permit networks to increase the incentives paid to issuers without providing net compensation if fees paid to a network included fees paid to a third-party processor affiliated with the network. In such case, an issuer would be permitted to recover those costs from merchants and acquirers through the interchange fee standard to the extent such costs were related to the authorization, clearing, or settlement of electronic debit transactions. If those recoverable costs were also included in the net compensation test, however, such processing costs could increase the amount of incentives that could be transferred by the network to the issuer. The network could then fund the additional incentives by increasing the network fees paid by merchants or acquirers.

Merchant commenters proposed two different approaches to address their concerns. First, they stated that the Board could limit the recoverable costs through the interchange fee standards to a processor's actual costs of authorizing, clearing, and settling an electronic debit transaction where debit card processing is outsourced to the third-party processor. Issuers, however, generally do not have knowledge of their processors' actual costs. Alternatively, these commenters recommended that the final rule exclude fees paid by an issuer for third-party processing from the total amount of fees paid to a network for purposes of the net compensation determination.

The Board agrees that the proposed approach could enable networks to substantially increase the incentives paid to issuers without violating the net compensation test and has determined that the test should be based on fees that are not incorporated into the interchange fee standard. Therefore, the Board has excluded from the net compensation test fees for issuer-

processor services paid by an issuer to a network or network affiliate. For similar reasons, the Board has excluded network processing, or switch, fees from the net compensation calculation because under the final rule such fees are also incorporated in the interchange fee standard.

New comment 6(b)-3 incorporates the proposed guidance describing the examples of fees paid by an issuer to a payment card network for purposes of the net compensation determination. Accordingly, the comment provides that fees paid by an issuer to a payment card network include, but are not limited to, network membership or licensing fees, and network administration fees. Fees paid by an issuer could also include fees for optional services provided by the network, such as risk management services.

Comment 6(b)-4 provides an example of circumstances that do not constitute net compensation to the issuer. In the example, an issuer receives an additional incentive payment from the network as a result of increased debit card transaction volume over the network during a particular calendar year. During the same period, however, the total network fees the issuer pays the payment card network with respect to electronic debit transactions also increase so that the total amount of fees paid by the issuer to the network continues to exceed the total amount of incentive payments received by the issuer from the network during that calendar year. Under these circumstances, the issuer does not receive net compensation from the network for electronic debit transactions. *See* comment 6(b)-4.i.

A few large issuers and a payment card network commented that the prohibition against circumventing or evading the interchange transaction fee standards should apply only to contractual arrangements between a payment card network and an issuer that are entered into on or after the date of enactment of the Dodd-Frank Act, July 21, 2010. The Board does not believe that such arrangements should be grandfathered, but the date on which such arrangements are

entered into would be included in the facts and circumstances analysis for circumvention or evasion. Such arrangements would, however, be subject to the prohibition against net compensation.

**D. Additional uses of circumvention or evasion authority**

As discussed above under § 235.5, trade associations representing small issuers, including credit unions, and one federal banking agency urged the Board to use its circumvention or evasion authority to ensure that the small issuer exemption in EFTA Section 920(a)(6) from the interchange transaction fee standards is given effect by the networks. In particular, these commenters were concerned that absent an express requirement on networks to adopt higher tiers of interchange fees for exempt issuers, such issuers would experience a significant reduction in interchange fee revenue, notwithstanding the exemption.

The Board notes that Section 920(a) imposes restrictions on the interchange fees that issuers may charge or receive and requires the Board to set standards regarding those fees--it does not confer authority on the Board to regulate the activities of networks (other than regarding the use of network fees to compensate issuers or to circumvent the interchange fee standards) or to require merchants to pay any particular level of fees. Moreover, although the statute provides an exemption from the interchange transaction fee standards for issuers with less than $10 billion in consolidated assets, the statute neither imposes an affirmative duty on networks to implement different interchange transaction fee rates for covered and non-covered issuers, nor requires merchants to pay a particular level of interchange fee revenue that may be collected by an exempt issuer. Thus, the Board does not believe that the circumvention or evasion authority confers authority on the Board to require networks to take specific actions to implement the

small issuer exception (which do not involve the use of network fees) or merchants to pay higher interchange fees to small issuers.

As discussed above, however, the final rule relies on specific authority granted in Section 920(a)(3)(B) to collect and publish information from issuers and networks to separately require networks to report to the Board the interchange revenue and related debit card volumes for exempt and covered issuers. The Board intends to publish on an annual basis the average interchange revenue received by covered and exempt issuers by network. The Board anticipates that greater transparency regarding network interchange policies will facilitate issuers' ability to more easily choose the networks that best serve their individual requirements, including the level of interchange transaction fees that apply to issuers on the network.

**VI. § 235.7 Limitations on payment card restrictions**

EFTA Section 920(b)(1) directs the Board to prescribe regulations with respect to two limitations set out in the statute regarding transaction processing. First, the Board must prescribe regulations prohibiting an issuer or payment card network from restricting the number of payment card networks on which an electronic debit transaction may be processed to fewer than two unaffiliated networks (network exclusivity restrictions).[157] Second, the Board must prescribe regulations that prohibit an issuer or payment card network from directly or indirectly inhibiting any person that accepts debit cards for payment from directing the routing of an electronic debit transaction through any network that may process that transaction (merchant routing restrictions).[158] Section 235.7 implements these limitations on payment card network restrictions.

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[157] *See* EFTA Section 920(b)(1)(A).
[158] *See* EFTA Section 920(b)(1)(B).

EFTA Sections 920(b)(2) and (3) impose certain limits on the ability of payment card networks to restrict merchants and other persons in establishing the terms and conditions under which they may accept payment cards. Specifically, EFTA Section 920(b)(2) prohibits a payment card network from establishing rules that prevent merchants from offering discounts or in-kind incentives based on the method of payment tendered to the extent that such discounts or incentives do not differentiate on the basis of the issuer or payment card network. In addition, EFTA Section 920(b)(3) prohibits a payment card network from establishing rules that prevent merchants from setting minimum transaction amounts for accepting credit cards to the extent that such minimums do not differentiate between issuers and payment card networks. These two statutory provisions are self-executing and are not subject to the Board's rulemaking authority.[159]

EFTA Section 920(b) does not provide a statutory exemption for small issuers, government-administered payment cards, or covered reloadable prepaid cards. Thus, the exemptions in section 235.5 of the rule do not extend to the prohibitions on network exclusivity arrangements and merchant routing restrictions under EFTA Section 920(b) implemented in § 235.7. *See* comment 7-1. As discussed below, however, the final rule provides a delayed effective date for certain types of debit cards to allow issuers to address significant technological or operational impediments to an issuer's ability to comply with the network exclusivity and routing provisions of the rule.

**A. § 235.7(a) Prohibition on Network Exclusivity**

EFTA Section 920(b)(1)(A) directs the Board to prescribe rules prohibiting an issuer or a payment card network from directly, or indirectly through any agent, processor, or licensed member of a payment card network, restricting the number of payment card networks on which

[159] The Board may, however, increase from $10 the minimum value amount that a merchant may set for credit card acceptance. EFTA Section 920(b)(3)(B).

an electronic debit transaction may be processed to fewer than two unaffiliated payment card networks. Section 235.7(a) implements the new requirement and prohibits an issuer or payment card network from restricting the number of payment card networks on which an electronic debit transaction may be processed to fewer than two unaffiliated networks, regardless of the method of authentication.

Currently, issuers, or in some cases, networks, control the merchant routing of electronic debit transactions. For example, for PIN debit transactions, current network rules typically allow issuers to specify routing priorities among the networks enabled on their cards.[160] These issuer-determined routing priorities require a transaction to be performed using an issuer's preferred network, even if a merchant may prefer to perform the transaction over a lower-cost network that is available for the transaction. Moreover, issuers can influence routing by limiting the networks enabled on their cards. For example, certain issuers have agreed to make a payment card network, or group of affiliated networks, the exclusive network(s) associated with the issuer's debit cards in exchange for certain benefits.[161] In particular, some issuers have agreed to restrict their cards' signature debit functionality to a single signature debit network and their PIN debit functionality to the PIN debit network that is affiliated with the signature debit network. Finally, at least one commenter raised concerns that certain signature debit network rules could be interpreted to prohibit issuers of debit cards carrying the signature network brand from enabling other signature debit networks or certain competing PIN debit networks on the same card.

[160] In other cases, a PIN debit network itself may require, by rule or contract, that PIN debit transactions be routed over that network when multiple PIN networks are available. These issuer- or network-directed priority rules are generally unnecessary for signature debit networks as there is typically only a single payment card network available per card for processing a signature debit transaction.

[161] Some issuers also negotiate or enroll in "exclusivity arrangements" with payment card networks for other business purposes. For example, an issuer may want to limit its participation to one network (or two affiliated networks) to reduce the membership and compliance costs associated with connecting to multiple networks.

Issuers and merchants, however, have different incentives regarding the routing of transactions, as described below.

Issuers may have a number of reasons to prefer that a particular payment card network carry their transactions. First, to the extent that interchange fees vary across networks, issuers would typically prefer the network with the highest interchange fee, all else equal. Second, in recent years, payment card networks have increasingly offered issuers other financial incentives in exchange for directing a substantial portion of their debit card transaction volume to their respective networks. For example, some issuers may agree to shift some or all of their debit card transaction volume to a network in exchange for higher incentive payments (such as volume-based payments or marketing support) or volume-based discounts on network fees charged to the issuer.

From the merchant perspective, the availability of multiple card networks for processing debit card transactions and the elimination of routing restrictions are attractive because they give merchants the flexibility to route transactions over the network that will result in the lowest cost to the merchant, such as through the network with the lowest interchange fee. This flexibility may promote direct price competition for merchants among the debit card networks that are enabled on the debit card. Accordingly, restrictions on this choice, such as network exclusivity arrangements, limit merchants' ability to route transactions over lower-cost networks and may reduce network price competition.

From the cardholder perspective, however, requiring that merchants have the ability to choose among multiple payment card networks enabled on debit cards—particularly multiple signature debit networks—could have adverse effects. In particular, such a requirement could limit the cardholder's ability to obtain certain card benefits. For example, a cardholder may

receive zero liability protection or enhanced chargeback rights only if a transaction is processed over a specific card network. Similarly, insurance benefits for certain types of transactions or purchases or the ability to receive text alerts regarding possible fraudulent activity may be tied to the use of a specific network.[162] Requiring multiple unaffiliated payment card networks, coupled with a merchant's ability to route electronic debit transactions over any of those networks, could reduce the ability of a cardholder to control the network over which a transaction would be routed. Consequently, such a requirement could reduce the likelihood that the cardholder would be able to obtain benefits that are specific to a particular card network. Moreover, it may be challenging for issuers or networks to market a benefit to cardholders if the issuer has to inform cardholders that they will receive certain benefits only if a merchant chooses to route their transaction over that particular network. On the other hand, cardholders and consumers generally may benefit to the degree that routing choice for merchants results in lower debit interchange fees with savings that are passed on to consumers in the form of lower prices for goods and services.

**1. Proposed rule**

In the proposed rule, the Board requested comment on two alternative approaches for implementing the restrictions on debit card network exclusivity. The first alternative (Alternative A) would require a debit card to have at least two unaffiliated payment card networks available for processing an electronic debit transaction. Under this alternative, an issuer could comply by, for example, having one payment card network available for signature debit transactions and a second, unaffiliated payment card network available for PIN debit transactions. The second alternative (Alternative B) would require a debit card to have at least

[162] These benefits are often provided for transactions routed over signature debit networks; they are less commonly available for PIN debit transactions.

two unaffiliated payment card networks available for processing an electronic debit transaction for each method of authentication available to the cardholder. For example, a debit card that can be used for both signature and PIN debit transactions would be required to offer at least two unaffiliated signature debit payment card networks and at least two unaffiliated PIN debit payment card networks. The second alternative recognized in part that PIN debit is not currently available for a significant number of merchants, either because they do not accept PIN debit or because PIN debit is not generally feasible in some retail environments, such as for Internet transactions, or transactions such as hotel stays and car rentals, where the final amount of the transaction cannot be determined at the time a transaction is authorized.

In the comments received, support for the two alternative approaches was divided primarily along issuer and merchant perspectives, with issuers strongly in support of Alternative A and merchants strongly in support of Alternative B. Payment card networks also favored Alternative A, while the one consumer group commenting on the issue favored Alternative B.

**2. Comments received**

Issuers and networks stated that Alternative A as proposed fully satisfies the text and intent of the network exclusivity restrictions in EFTA Section 920(b)(1)(A). Issuers and networks further asserted that the approach taken in proposed Alternative B is unsupported by the statute, which does not distinguish between transactions by the method of cardholder authentication. Issuers and networks also noted that Alternative A would be far less disruptive to the payment system because many institutions are already in compliance with Alternative A and support multiple unaffiliated PIN networks.

By contrast, issuers and networks expressed significant concern about the operational cost and burden of implementing Alternative B, which in their view is not currently feasible

because it would require enabling multiple signature networks on a card. In particular, issuers, networks, and card processors noted several changes that would be required in order to implement Alternative B. Among these changes, these commenters stated that merchants, acquirers, issuer processors, and issuers would have to replace routing logic to ensure that authorization, settlement, dispute processing, and fraud reporting records for electronic debit transactions are routed to the network selected by the merchant, instead of basing the logic on the first digit of the account number or card BIN. These commenters also suggested that point-of-sale terminals would have to be re-programmed or replaced to ensure that transactions can be routed to the appropriate network. Issuers also cited the expense of negotiating contracts with and participating in additional networks, including the costs of complying with multiple network rules, in order to comply with Alternative B, a burden that could be particularly onerous for smaller issuers. Moreover, several issuers contended that under the proposed interchange fee standards, they would be unable to recover the full costs of their current programs, much less the additional costs required to comply with Alternative B.

Issuers and networks also expressed concern that Alternative B would discourage investment and innovation in new authentication technologies. For example, these commenters argued that networks and issuers may have less incentive to develop and deploy new methods of authentication if they are required to share that technology with other parties to ensure that the new authentication method could be used on multiple unaffiliated networks.

Several issuers asserted that in many cases where PIN debit is unavailable, it is due to a merchant's choice not to offer PIN debit. These issuers also cited the development of alternative technologies that could facilitate the use of PIN debit in additional retail environments, including Internet transactions.

Finally, many issuers stated their belief that Alternative B is more likely to cause consumer confusion and potentially frustrate consumer choice to the extent that certain cardholder benefits, such as zero liability, enhanced chargeback rights, rewards, or insurance, are tied to the use of a particular network. In their view, Alternative B, with the potential of requiring four networks on a debit card, would make it less likely that a cardholder would receive those benefits if a merchant opted to route a transaction over a different network.

Merchants strongly urged the Board to adopt Alternative B to require debit cards to carry at least two unaffiliated networks for each method of authentication in order to create network competition for every transaction. Merchants argued that Alternative B would give them the ability to discipline the level of network processing fees by routing transactions to the lowest cost network. A consumer group commenter agreed that Alternative B was more likely to lead to greater competition between networks through lower transaction fees and better services, which would in turn benefit consumers through lower prices for goods and services.

Merchant commenters described a number of situations in which Alternative B would provide merchants with greater routing choice. These commenters observed that certain retail environments, such as Internet transactions, cannot readily accept PIN debit under current technology. These commenters further argued that, in other cases, certain types of debit cards may not be suited for PIN debit, such as health care cards that require specialized transaction qualification or substantiation systems that currently operate only on signature debit networks. In each of these circumstances, a merchant would not have any routing options under Alternative A. Merchants also noted that under Alternative A, even where both signature and PIN debit are available, a merchant's routing choice would be limited to a single network once the consumer has selected his or her authentication method. Merchants thus asserted that Alternative B was

most consistent with statutory purpose because it would not limit merchant routing choice either by the way a transaction is authorized or by the type of transaction.

Finally, merchant commenters believed that Alternative B was more likely to foster new entrants offering signature debit to increase market competition. These commenters also predicted that new PIN debit networks would enter the market if Alternative B were adopted. Merchant commenters thus rejected issuer assertions regarding the operational burden associated with Alternative B, arguing that existing infrastructure already in place to support multiple PIN networks could be leveraged to also support multiple signature debit networks.

### 3. § 235.7(a)(1) – General rule

The final rule adopts Alternative A (at least two unaffiliated payment card networks) with respect to the network exclusivity provisions. The Board believes that Alternative A is most consistent with EFTA Section 920(b)(1)(A), which provides that an issuer and payment card network do not violate the prohibition against network exclusivity arrangements as long as the number of payment card networks on which an electronic debit transaction may be processed is not limited to fewer than two unaffiliated payment card networks. The plain language of the statute does not require that there be two unaffiliated payment card networks available to the merchant for each method of authentication. In other words, the statute does not expressly require issuers to offer multiple unaffiliated signature and multiple unaffiliated PIN debit card network choices on each card.

The Board has also considered the compliance burden presented by the two alternative approaches and the benefits to consumers of each approach. The Board understands that many issuers, particularly small issuers, are already in compliance with Alternative A, as they may already have multiple unaffiliated PIN networks enabled on their debit cards, or a signature

network and an unaffiliated PIN network. Thus, Alternative A would minimize the compliance burden on institutions, particularly small issuers that might otherwise be adversely affected by a requirement to have multiple networks for each method of debit card authentication. Alternative A would also present less logistical burden on the payment system overall as it would require little if any re-programming of routing logic by issuers, networks, issuer processors, and acquirers.

From the consumer perspective, as noted above, requiring multiple payment card networks could limit the cardholder's ability to obtain card benefits that are tied to a particular network, such as zero liability protection or the ability to receive text alerts regarding possible fraud. Moreover, explaining the circumstances under which a cardholder may receive those benefits could be challenging for issuers, regardless of the alternative approach taken in the final rule. The Board believes that Alternative A would result in less consumer confusion than might otherwise result under Alternative B.

The Board acknowledges that Alternative A provides merchants fewer routing options with respect to certain electronic debit transactions compared to Alternative B. Nonetheless, under Alternative A, merchants that currently accept PIN debit would have routing choice with respect to PIN debit transactions in many cases where an issuer chooses to participate in multiple PIN debit networks. Moreover, the Board notes that EFTA Section 920(b)(1)(A) prohibits an "issuer or payment card network" from restricting the number of payment card networks on which an electronic debit transaction may be processed. To the extent a merchant has chosen not to accept PIN debit, the merchant, and not the issuer or the payment card network, has restricted the available choices for routing an electronic debit transaction under Alternative A. Similarly,

where a consumer selects signature or PIN debit as the method of payment, the consumer, and not the issuer or the payment card network, has restricted the available routing choices.

The Board further understands that there exist emerging PIN debit products and technologies that would allow PIN debit to be used in additional retail environments where PIN debit is not generally offered, such as for online purchases. Some billers and at least one online merchant accept transactions that are routed over PIN debit networks, without requiring the cardholder to provide his or her PIN.[163] The Board anticipates that the elimination of network and issuer-based routing restrictions may further promote innovation to facilitate the use of PIN debit in additional retail environments. *See* discussion in relation to § 235.7(b).

Finally, the Board is persuaded that Alternative B and its requirement to enable multiple unaffiliated payment card networks on a debit card for each method of card authentication could potentially limit the development and introduction of new authentication methods. Although PIN and signature are the primary methods of debit card transaction authentication today, new authentication measures involving biometrics or other technologies may, in the future, be more effective in reducing fraud. An issuer, however, may be unable to implement these new methods of card authentication if the rule requires that such transactions be capable of being processed on multiple unaffiliated networks offering the new authentication method.

Thus, for the foregoing reasons, the final rule provides that the network exclusivity provision in § 235.7(a)(1) is satisfied as long as an electronic debit transaction may be processed on at least two unaffiliated payment card networks. Comment 7(a)-1 clarifies that § 235.7(a)(1) does not require an issuer to have multiple, unaffiliated networks available for each method of

[163] A large online merchant is currently processing some online customer payments as PIN-less debit transactions. *See* http://www.amazon.com/gp/help/customer/display.html/ref=hp_518224_pinless?ie=UTF8&nodeId=518224&#pinless

cardholder authentication. Under the final rule, it would be sufficient, for example, for an issuer to issue a debit card that operates on one signature-based card network and on one PIN-based card network, as long as the two card networks are not affiliated. Alternatively, an issuer could issue a debit card that operates on two or more unaffiliated signature-based card networks, but is not enabled for PIN debit transactions, or that operates on two or more unaffiliated PIN-based card networks, but is not enabled for signature debit transactions.

**4. § 235.7(a)(2)-(3) Permitted and prohibited arrangements**

Proposed § 235.7(a)(2) described three circumstances in which an issuer or payment card network would not satisfy the general requirement to have at least two unaffiliated payment networks on which an electronic debit transaction may be processed, regardless of which of the alternatives is adopted. The proposed provision generally described circumstances in which a payment card network that is added to a debit card would not satisfy the network exclusivity provisions in § 235.7(a)(1) due to geographic or merchant coverage restrictions. *See* proposed §§ 235.7(a)(2)(i) and (ii). The proposal also prohibited, as an impermissible exclusivity arrangement, contractual restrictions or limitations set by a payment card network on an issuer's ability to contract with another payment card network. *See* proposed § 235.7(a)(2)(iii).

The final rule generally adopts the proposed provisions with modifications and adjustments in response to comments. Section 235.7(a)(3) of the final rule describes prohibited exclusivity arrangements by networks. Proposed § 235.7(a)(2)(i) provided that an issuer would not satisfy the requirement to have at least two unaffiliated payment card networks enabled on a debit card by adding a payment card network that is not accepted on a nationwide basis. Thus, for example, an issuer could not comply with the network exclusivity provision by having a second unaffiliated payment card network that is accepted in only a limited geographic region of

the country. The proposal further provided, however, that an issuer could comply with proposed §235.7(a)(1) if, for example, the debit card operates on one national network and multiple geographically limited networks that are unaffiliated with the first network and that, taken together, provide nationwide coverage. The Board also requested comment on the impact of the proposed approach on the viability of regional payment card networks and on small issuers that are more likely to use regional networks for their debit cards.

Several issuers objected to the proposed condition that a payment card network operate on a nationwide basis, asserting that the rule should permit issuers broad discretion to select unaffiliated networks that serve their market areas and cardholder needs, and that a network with coast-to-coast coverage may not be appropriate for all issuers. Issuers and a few networks expressed concern that smaller regional networks would be affected adversely if the nationwide coverage requirement were adopted, because the requirement would reduce competition between large and small networks. A few issuers commented that small issuers that currently use regional networks would incur additional costs to add nationwide PIN networks under the proposed rule, but would receive little benefit as most of their card transactions currently take place within their network's geographic coverage area. Moreover, commenters argued that requiring nationwide coverage would effectively prevent the establishment of new networks, which historically have started in small geographic markets.

Issuers and networks suggested a number of alternative approaches to the proposed rule, including providing that a network must have general acceptance availability within the cardholder's area of residence; allowing a network to be added as long as is it accepted at the nation's largest retailers; and providing that a regional network must establish network connectivity or reciprocal arrangements with other networks that would allow a card to have

nationwide coverage by routing transactions to the regional network via a gateway arrangement. A few issuers and one regional network suggested a coverage test under which a certain percentage of a debit card's transactions must take place within a network's geographic coverage area.

Merchants generally argued that a network with limited geographic acceptance would not comply with the statute because there would be portions of the United States where merchants would not have a viable second debit network option. Merchants further argued that an issuer could add other regional networks such that the networks would collectively provide merchants the ability to route an electronic debit transaction over at least two unaffiliated payment card networks throughout most of the country. In that regard, merchants disagreed that the proposed rule would reduce the viability of regional networks, contending that such networks would likely gain volume if they are enabled on additional debit cards to comply with the rule.

The final rule in § 235.7(a)(2) describes the necessary conditions to satisfy the requirement to have at least two unaffiliated payment card networks available for processing an electronic debit transaction under § 235.7(a)(1).[164] As in the proposal, under the final rule, an issuer may satisfy the network exclusivity provisions of § 235.7(a)(1) if an electronic debit transaction may be processed on at least two unaffiliated payment card networks that operate throughout the United States. Debit cards that operate on at least two nationwide payment card networks would most effectively provide merchants routing choice regardless of where a cardholder uses the card.

The Board does not believe, however, that a payment card network operating on a nationwide basis should be the sole means by which an issuer could satisfy the network

[164] For clarity, the final rule describes the geographic coverage and other requirements for payment card networks that would satisfy the network exclusivity provisions through positive requirements, instead of describing payment card networks that would *not* satisfy the rule.

exclusivity provisions. An overly restrictive nationwide coverage requirement may reduce network choice for issuers, with little benefit to merchants, particularly where the vast majority of debit card transactions by an issuer's cardholders may take place within the network's geographic coverage area. Accordingly, the final rule provides additional flexibility for issuers by permitting an issuer to comply with the network exclusivity provisions by enabling on its debit cards a network that does not, by rule or policy, restrict the operation of the network to a limited geographic area, specific merchant, or particular type of merchant or transaction, and that has taken steps reasonably designed to enable the network to be able to process the electronic debit transactions that the network reasonably expects will be routed to it, based on projected transaction volume. A smaller network could be used to help satisfy an issuer's requirement to enable two unaffiliated networks if the network was willing to expand its coverage in response to increased merchant demand for access to its network, and the smaller network meets the other requirements of § 235.7(a) for a permitted arrangement. If, however, the network's policy or practice was to limit such expansion, it would not qualify as one of the two unaffiliated networks. *See* comment 7(a)-2.i.

Proposed § 235.7(a)(2)(ii) provided that adding an unaffiliated payment card network that is accepted only at a small number of merchant locations or for limited merchant types would not comply with the requirement to have at least two unaffiliated payment card networks on a debit card. For example, an issuer could not solely add, as an unaffiliated payment card network, a network that is accepted only at a limited category of merchants (for example, at a particular supermarket chain or at merchants located in a particular shopping mall). *See* proposed comment 7(a)-4.ii.

Merchant comments supported the proposed prohibition on limited merchant coverage networks. Issuers and networks did not object to proposed § 235.7(a)(2)(ii). The final rule adopts a prohibition on networks that are limited to particular merchants or merchant types as part of the necessary conditions set out in § 235.7(a)(2) and expands the prohibition to include networks that are limited to particular transaction types. Proposed comment 7(a)-4.ii is also adopted, and is redesignated as comment 7(a)-2.ii in the final rule.

Section 235.7(a)(2) of the final rule also provides that a payment card network that has not taken steps reasonably designed to enable the network to process the electronic debit transactions that the network reasonably expects will be routed to it would not count towards the issuer's requirement to have at least two unaffiliated payment card networks on which an electronic debit transaction may be processed. The new prohibition responds to merchant comments that expressed concern that issuers may respond to the network exclusivity provisions by adding small, capacity-constrained networks with the expectation that such networks would not have the capacity to handle their additional volume such that transactions would default to a larger payment card network on the card. The Board agrees that such arrangements would not meet the intent to provide merchants with routing choice in those cases where a network does not take steps reasonably designed to enable the network to meet reasonably foreseeable demand for processing transactions given the number of cards enabled for processing over the network and the general usage patterns of the cardholders. The new prohibition is not intended, however, to address the rare circumstances where a network may be off-line for technical reasons and an electronic debit transaction is processed on a different payment card network on a stand-by basis or where volume is unexpected. *See* comment 7(a)-2.iii.

Proposed § 235.7(a)(2)(iii) prohibited a payment card network from restricting or otherwise limiting an issuer's ability to contract with any other payment card network that may process an electronic debit transaction involving the issuer's debit cards. Proposed comment 7(a)-5 provided examples of prohibited restrictions on an issuer's ability to contract with other payment card networks, including network rules or guidelines that limited the number or location of network brands, marks, or logos that may appear on a debit card. *See* proposed comment 7(a)-5.ii. The prohibition on payment card network restrictions on an issuer's ability to contract with other networks is adopted with certain revisions for clarity and is redesignated as § 235.7(a)(3)(i). *See also* comment 7(a)-3.

Depository institutions trade associations commented that the proposed network contracting prohibition was overbroad and impermissibly prohibited all arrangements between networks and issuers that in *any way* restrict the networks made available on a debit card for processing a transaction. In their view, the provision as proposed would prohibit an issuer from agreeing to limit the number of networks enabled on its debit cards to no more than two networks per method of authentication even if such restriction would not violate either Alternative A or B. One issuer urged the Board to clarify that the proposed provision is directed at rules-based, blanket prohibitions against an issuer enabling a competing network.

The examples in proposed comment 7(a)-5 elicited several comments from two payment card networks expressing concern that the proposed examples conflicted with established principles in trademark law. In particular, these commenters argued that the example of network rules limiting the number or location of network brands, marks, or logos in comment 7(a)-5.ii would impermissibly restrict their ability to protect their investment in their marks or brands and their ability to limit consumer confusion. These networks also urged the Board to clarify that the

proposed prohibition is not intended to change the card design and related security requirements that networks may apply to their payment card products, such as size and location requirements for the network logo, card account number, and expiration date, as well as the location of the magnetic stripe and card verification number. One processor affiliated with a payment card network urged the Board to include safe harbor language in the final rule to ensure that a payment card network could not assert a trademark infringement or other claim against an acquirer or network for routing transactions on that network's branded card through competing networks enabled on the card in order to prevent merchants from exercising routing choice as intended under EFTA Section 920(b)(1)(B).

The final rule adopts the prohibition on payment card network restrictions or limitations on an issuer's ability to contract with other payment card networks that may process an electronic debit transaction generally as proposed with certain revisions in § 235.7(a)(3). Specifically, § 235.7(a)(3) provides that, for purposes of the network exclusivity provisions in § 235.7(a)(1), a payment card network may not restrict or otherwise limit an issuer's ability to contract with any other payment card network that may process an electronic debit transaction involving the issuer's debit cards. Thus, for example, the rule prohibits a network from limiting or otherwise restricting, by rule, contract, or otherwise, the other payment card networks that may be enabled on a particular debit card. *See* comment 7(a)-3.i. The rule would also prohibit a network from specifying the other payment card networks that may be enabled on a particular debit card in order to comply with § 235.7(a)(1). Comment 7(a)-3.i includes as an example of a prohibited rule or contract any express prohibition on an issuer's ability to offer certain specified payment card networks on the debit card or any requirement that only certain specified networks may be offered on the card.

Comment 7(a)-3.ii clarifies that § 235.7(a)(3) would also prohibit network rules or guidelines that allow only that network's (or its affiliated network's) brand, mark, or logo to be displayed on a particular debit card, or that otherwise limit the ability of brands, marks, or logos of other payment card networks to appear on the debit card. Without this prohibition, network rules could inhibit an issuer's ability to add other payment card networks to a debit card, particularly if the other networks also require that their brand, mark, or logo appear on a debit card in order for a card to be offered on that network. Comment 7(a)-3.ii is revised from the proposed comment, which would have listed, as an example of a prohibited network restriction on an issuer's ability to contract with other networks, any limits on the number or location of network brands, marks, or logos that may appear on the card. In the final rule, only contract provisions limiting the ability of one or more network brands, marks, or logos to appear on the debit card are expressly prohibited, as such restrictions could prevent a consumer from knowing the networks that are enabled on a debit card. Thus, the rule is not intended to restrict networks from imposing branding, card-design, or security requirements on their cards to promote brand recognition and consistency across payment card types or to limit consumer confusion as long as such requirements do not effectively limit the ability of other payment card networks to appear on the debit card, such as when multiple signature networks require their logo to appear in the same location on the card. The final rule does not, however, otherwise address other trademark-related issues raised by commenters as such issues are outside the scope of the rule.

Notwithstanding the examples in comment 7(a)-3, comment 7(a)-4 in the final rule clarifies that nothing in the rule requires that a debit card display the brand, mark, or logo of each payment card network over which an electronic debit transaction may be processed. For example, the rule does not require a debit card that operates on two or more different unaffiliated

payment card networks to bear the brand, mark, or logo for each card network. The Board believes that this flexibility is necessary to facilitate an issuer's ability to add (or remove) payment card networks to a debit card without being required to incur the additional costs associated with the reissuance of debit cards as networks are added (or removed). The Board received one comment supporting comment 7(a)-6 as proposed and it is adopted without substantive change, redesignated as comment 7(a)-4 in the final rule.

In its proposal, the Board requested comment as to whether it was necessary to address in the rule a payment card network's ability to require an issuer to commit a certain volume, percentage share, or dollar amount of transactions over the network given that volume, percentage share, or dollar amount commitments generally could only be given effect through issuer or payment card network priorities that direct how a particular debit card transaction should be routed by a merchant. The Board noted in the proposal, however, that such issuer or payment card network routing priorities could be prohibited by the proposed limitations on merchant routing restrictions.

Issuers and one card processor agreed that the merchant routing provisions in proposed § 235.7(b) would make explicit rules relating to volume, percentage share, or dollar amount commitments unnecessary given that merchants would be able to choose the payment card network for processing a transaction. Merchants, however, believed that if the Board were to adopt Alternative A with respect to the network exclusivity provisions, it should prohibit a network's ability to impose volume, percentage share, or dollar amount commitments notwithstanding the routing provisions in § 235.7(b). According to these merchant commenters, if routing options were reduced to a single signature debit and a single PIN debit option,

networks and issuers would continue to be able to reasonably predict and influence signature debit volumes.

Under the final rule, the issuer's ability to influence volume, percentage share, or dollar amount of transactions that are processed through any particular network will be significantly reduced, given that merchant routing preferences will take priority over issuer and network routing preferences (see discussion of §235.7(b) below). In addition, as discussed above, any network that issuers add to debit cards to fulfill the requirement for two unaffiliated networks in § 235.7(a)(1) must meet the requirements of § 235.7(a)(2). The Board recognizes that issuers may be able to use incentives to influence cardholders to use a particular authentication method (signature or PIN) at the point of sale. At the same time, however, merchants may also steer consumers toward a particular authentication method through, for example, default settings on transaction terminals or discounts for choosing certain payment methods. Given the issuer's limited ability to control volume, percentage share, or dollar amount of transactions over a particular network, the Board has determined not to address this issue in the final rule.

A few issuers and two payment card networks opposed the prefatory language in proposed § 235.7(a)(2) interpreting EFTA Section 920(b)(1)(A)'s prohibition on network exclusivity arrangements as *requiring* a debit card "to have at least two unaffiliated payment card networks on which an electronic debit transaction may be processed." These commenters argued that EFTA Section 920(b)(1)(A) should only be read as a prohibition on "restricting" the number of payment card networks on which an electronic debit transaction may be processed to fewer than two unaffiliated payment card networks. In their view, the statute does not mandate a minimum number of payment card networks to be enabled on a debit card as long as an issuer or a payment card network does not affirmatively create any impediments to the addition of

unaffiliated payment card networks on a debit card. Thus, these commenters argued that the statute does not prohibit voluntary arrangements by an issuer to limit the number of payment card networks on a card.

EFTA Section 920(b)(1)(A) states that "an issuer or payment card network shall not directly or through any agent, processor, or licensed member of a payment card network, by contract, requirement, condition, penalty, or otherwise, restrict the number of payment card networks on which an electronic debit transaction may be processed" to fewer than two unaffiliated payment card networks. Thus, by its terms, the statute's prohibition on exclusivity arrangements is not limited to those that are mandated or otherwise required by a payment card network. In the Board's view, individual issuer decisions to limit the number of payment card networks enabled on a debit card to a single network or affiliated networks are also prohibited as a "direct" restriction on the number of such networks in violation of the statute. The Board believes that to conclude otherwise would enable an issuer to eliminate merchant routing choice for electronic debit transactions with respect to its cards, contrary to the overall purpose of EFTA Section 920(b). Accordingly, the final rule adopts the substance of proposed comment 7(a)-7 and prohibits voluntary exclusivity arrangements with respect to debit cards (now designated as comment 7(a)-5). The final comment 7(a)-5 provides that the network exclusivity provision in § 235.7(a) requires that debit cards must be enabled on at least two unaffiliated payment card networks in all cases, even if the issuer is not subject to any rule of, or contract, arrangement or other agreement with, a payment card network requiring that all or a specified minimum percentage of electronic debit transactions be processed on the network or its affiliated networks.

Comment 7(a)-6 (designated 7(a)-8 in the proposal) clarifies that the network exclusivity rule does not prevent an issuer from including an affiliated payment card network among the

networks that may process an electronic debit transaction for a particular debit card, as long as at least two of the networks that accept the card are unaffiliated. The Board proposed two different versions of comment 7(a)-6 based on the appropriate network exclusivity alternative. No comments were received under either version and the final rule adopts the Alternative A version of the comment as proposed. The final comment 7(a)-6 clarifies that an issuer is permitted to offer debit cards that operate on both a signature debit network as well as an affiliated PIN debit network, as long as at least one other payment card network that is unaffiliated with either the signature or PIN debit networks also accepts the card.

**5. § 235.7(a)(4) Subsequent affiliation**

Proposed § 235.7(a)(3) addressed circumstances where previously unaffiliated payment card networks subsequently become affiliated as a result of a merger or acquisition. Under these circumstances, an issuer that issues cards with only the two previously unaffiliated networks enabled would no longer comply with § 235.7(a)(1) until the issuer is able to add an additional unaffiliated payment card network to the debit card. The Board requested comment regarding whether 90 days after the date on which the prior unaffiliated payment card networks become affiliated provides sufficient time for issuers to add a new unaffiliated network in order to comply with the rule.

Several issuers and one processor stated that the proposed 90-day window for adding a new network in the event of a payment network merger was too short. Some issuers suggested a transition period of at least one year, while one large issuer suggested 24 months from the date the merger closes.

The final rule (§ 235.7(a)(4)) requires issuers to add an additional unaffiliated payment card network to a debit card within six months after the date of a merger or acquisition that

causes the previously unaffiliated payment card networks enabled on a debit card to become affiliated. Based on its outreach, the Board understands that adding an additional PIN network to a debit card can be accomplished in a relatively short period of time, particularly in circumstances in which an issuer uses a processor that is already connected to several PIN debit networks. The additional period of time in the final rule provides issuers more time if necessary to negotiate new agreements and establish connectivity with the new network.

### 6. Applicability to all form factors

New comment 7(a)-7 addresses the applicability of the network exclusivity provisions with respect to cards, codes, or devices that may be issued in a form factor other than a card. The Board requested comment on how to apply the network exclusivity provisions to such cards, codes, or devices given that they may be capable of being processed using only a single authentication method. For example, a transaction using a mobile phone embedded with a contactless chip may be able to be processed only as a signature debit transaction or only on certain networks. The Board noted that under the proposed rule (under either alternative), the issuer would be required to add at least a second unaffiliated signature debit network to the device to comply with the requirements of § 235.7(a). The Board thus requested comment on the effect of the network exclusivity provisions in § 235.7(a) on the development of these devices in the future.

Some issuers, processors, and networks commented that requiring new payment devices or methods to be processed by multiple networks would inhibit the development of these innovations. They further asserted that it was unnecessary for the Board's rule to cover new form factors given that merchant adoption and acceptance of these innovations is voluntary. One payment card network argued that a consumer's decision to use an alternative form factor in a

transaction was analogous to a cardholder's election to initiate an electronic debit transaction by signature or PIN debit at the point of sale. As an alternative approach, one processor urged the Board to clarify that alternative form factors would be compliant if they are associated with a "companion card" that is compliant, even if the alternative form factor itself may only be used to initiate transactions over a single network.

Merchants and one payment card network, by contrast, urged the Board to require the addition of a second unaffiliated network for any payment code or device, including cards with contactless features. In their view, current limitations restricting the use of contactless devices on a network have been attributable to a desire to limit competition from PIN networks rather than technological issues presented by the PIN networks.

The Board believes the statute is clear that the network exclusivity provisions apply to electronic debit transactions involving any device that meets the definition of "debit card" under EFTA Section 920(c)(2). Accordingly, comment 7(a)-7 of the final rule provides that the network exclusivity provisions in § 235.7(a) apply to all "debit cards," as that term is defined in EFTA Section 920(c)(2), regardless of whether the debit card is issued in card form or in the form of another "payment code or device." The final comment thus clarifies that all debit cards must be accepted on at least two unaffiliated payment card networks on which an electronic debit transaction may be processed. Moreover, this is the case even if a supplemental debit card is issued in connection with a card, code, or other device that fully complies with the rule.

**B. § 235.7(b) Prohibition on Merchant Routing Restrictions**

EFTA Section 920(b)(1)(B) requires the Board to prescribe rules prohibiting an issuer or payment card network from directly or indirectly "inhibit[ing] the ability of any person who accepts debit cards for payments to direct the routing of electronic debit transactions for

processing over any payment card network that may process such transactions." The Board is implementing this restriction in § 235.7(b).

As noted above, the rules of certain PIN debit payment card networks currently require PIN debit transactions to be routed based on the card issuer's designated preferences when multiple PIN debit networks are available to process a particular debit card transaction. In other cases, the PIN debit network itself may require, by rule or contract, that the particular PIN debit transaction be routed over that network when multiple PIN networks are available.[165] Such rules or requirements prevent merchants from applying their own preferences with respect to routing the particular debit card transaction to the PIN debit network that will result in the lowest cost to the merchant. EFTA Section 920(b)(1)(B) prohibits these practices. As a result, in practice, this means that merchants, not issuers or networks, will be able to direct the routing of transactions.

Proposed § 235.7(b) prohibited both issuers and payment card networks from inhibiting, directly, or through any agent, processor, or licensed member of the network, by contract, requirement, condition, penalty, or otherwise, a merchant's ability to route electronic debit transactions over any payment card network that may process such transactions. Issuers commented generally that the routing provision would likely frustrate consumer choice and their ability to receive cardholder benefits, such as zero liability and enhanced chargeback rights, which are unique to a particular network. Issuers also expressed concern that the routing provisions would make it difficult for them to explain to their customers the circumstances under which they would or would not receive such issuer-specific benefits. Issuers and one payment card network urged the Board to require merchants to continue to honor consumer choice for routing of the electronic debit transaction or, at a minimum, to require merchants to inform

[165] These issuer- or network-directed priority rules are generally unnecessary for signature debit networks as there is only a single payment card network available for processing a signature debit transaction.

cardholders of the network that will carry the transaction before the transaction is consummated to minimize consumer confusion regarding the network that will process the transaction. By contrast, merchants strongly supported the proposed provision.

Section 235.7(b), which tracks the language of the EFTA Section 920(b)(1)(B), is adopted as proposed. The final rule does not include any requirement on merchants to disclose the network selected to process a particular electronic debit transaction as some commenters suggested. EFTA Section 920(b) does not impose such a requirement, and the Board believes that issues regarding merchant card acceptance practices are best left to the individual network-merchant relationship.

In the proposal, the Board did not interpret EFTA Section 920(b)(1)(B) to grant a person that accepts debit cards the ability to process an electronic debit transaction over *any* payment card network of the person's choosing. Rather, the Board interpreted the phrase "any payment card network that may process such transactions" to mean that a merchant's choice is limited to the payment card networks that have been enabled on a particular debit card. Accordingly, the Board proposed comment 7(b)-1 to clarify that the prohibition on merchant routing restrictions applies solely to the payment card networks on which an electronic debit transaction may be processed with respect to a particular debit card.

Issuers and networks agreed with the proposed comment providing that a merchant's routing choices should apply only with respect to the networks that the issuer has enabled to process transactions for the card. By contrast, comments of some merchants and a payments processor stated that the plain language of the statute indicated that Congress intended merchants to be able to process electronic debit transactions over *any* payment card network that may process such transactions. In these commenters' view, had Congress intended to limit the

routing choice mandate to the payment card networks enabled by the issuer on a particular debit card, it could have done so by statute.

The Board continues to believe that the appropriate reading of the routing provisions in EFTA Section 920(b)(1)(B) limits merchant routing choice to the card networks that an issuer has chosen to enable on a cardholder's card. In particular, the Board notes that allowing merchants to route transactions over any network, regardless of the networks enabled on the debit card, would render superfluous the requirement in EFTA Section 920(b)(1)(A) that electronic debit transactions have the ability to be processed over at least two unaffiliated networks. Also, the issuer (or its processor) must be connected to a network for that network to be able to route the transaction information and data, and the issuer must have an agreement with the network to settle transactions cleared over that network. Accordingly, comment 7(b)-1 is adopted as proposed with some revisions to clarify that the rule does not permit a merchant to route the transaction over a network that the issuer did not enable to process transactions using that debit card.

Proposed comment 7(b)-2 provided examples of issuer or payment card network practices that would inhibit a merchant's ability to direct the routing of an electronic debit transaction in violation of § 235.7(b). The proposed comment addressed both practices relating to the sending of transaction information to the issuer and certain practices that may affect the network choices available to the merchant at the time the transaction is processed. The final commentary adopts the examples in 7(b)-2 generally as proposed with certain adjustments for clarity.

The first example of an impermissible restriction on a merchant under proposed comment 7(b)-2 addressed issuer or card network rules or requirements that prohibit a merchant from

"steering," or encouraging or discouraging, a cardholder's use of a particular method of debit card authentication. *See* proposed comment 7(b)-2.i. For example, merchants may want to encourage cardholders to authorize a debit card transaction by entering their PIN, rather than by providing a signature, because PIN debit carries a lower risk of fraud than signature debit. Merchants supported the proposed example in comment 7(b)-2.i, stating that any rules that prohibit steering or that could inhibit merchants' ability to steer – including anti-discrimination or no-surcharge rules – should be invalidated by § 235.7(b).

A payment card network and a few issuers opposed the Board's statement in the supplementary information that, under the proposed example, merchants would be permitted to block a consumer's choice of signature debit. These commenters expressed concern that if merchants were permitted to block the use of signature debit, consumers could be misled about which payment networks' cards the merchant accepted. In addition, issuer and payment card network commenters stated that allowing merchants to block signature debit would take away consumers' ability to limit exposure of their PIN if they wanted to use their debit card.

This example is adopted as proposed. As discussed above under § 235.7(a), an issuer may comply with the network exclusivity provisions by enabling a debit card with a single signature debit network and a single unaffiliated PIN debit network. For such cards, a merchant can influence routing choice by, for example, determining whether a debit card is PIN-enabled and, if it is, prompting the cardholder to input his or her PIN, rather than asking the consumer whether the transaction is "debit" or "credit."

The second example of a prohibited routing restriction is network rules or issuer-designated priorities that direct the processing of an electronic debit transaction over a specified payment card network or its affiliated networks. *See* comment 7(b)-2.ii.) Thus, for example, if

multiple networks were available to process a particular debit transaction, neither the issuer nor the networks could specify the network over which a merchant would be required to route the transaction (or be required to avoid in routing the transaction). Nothing in comment 7(b)-2.ii, however, is intended to prevent an issuer or payment card network from designating a default network for routing an electronic debit transaction in the event a merchant or its acquirer or processor does not indicate a routing preference. In addition, comment 7(b)-2.ii does not prohibit an issuer or payment card network from directing that an electronic debit transaction be processed over a particular network if required to do so by state law.[166] Although one commenter urged the Board to preempt state laws that mandate the routing of electronic debit transactions to prevent networks or other parties from securing favorable state laws requiring routing to a particular network, the final rule does not adopt the recommendation because state laws do not constitute issuer or network restrictions on merchant routing that are prohibited by the statute. Proposed comment 7(b)-2.ii is adopted as proposed, with the clarification that issuer and network practices that direct the processing of a transaction away from a specified network or its affiliates is prohibited.

Under the third example, a payment card network could not require a specific payment card network based on the type of access device provided by the cardholder. *See* comment 7(b)-2.iii. For example, a payment card network would be prohibited from requiring that an electronic debit transaction that is initiated using "contactless" or radio frequency identification device (RFID) technology be processed over only a signature debit network. The Board received one comment from a processor that supported the example. The Board is adopting the example with a revision to clarify that the example applies to payment card networks rather than authentication methods.

[166] *See*, e.g., Iowa Code § 527.5.

New comment 7(b)-3 clarifies that the prohibition on merchant routing restrictions does not prohibit a payment card network from offering payments or incentives to merchants to encourage the merchant to route electronic debit card transactions to that network for processing. The Board believes that a payment card network does not impermissibly "inhibit" the merchant's ability to route transactions over any available networks within the scope of the prohibition in EFTA Section 920(b)(1)(B) by offering such incentives because it is the merchant itself that has voluntarily chosen to direct electronic debit transactions over a particular network in exchange for consideration from the network.

Although proposed § 235.7(b) provides merchants control over how an electronic debit transaction is routed to the issuer, the proposed rule did not require that a merchant make network routing decisions on a transaction-by-transaction basis. As stated in the supplementary information in the proposal, such a requirement may necessitate systematic programming changes and equipment upgrades, may be operationally infeasible and cost-prohibitive in the near term, and is not needed to carry out the purpose of these provisions.[167] Instead, under comment 7(b)-3 as proposed, it is sufficient to allow a merchant to designate network routing decisions in a routing table in advance for its transactions, similar to the way that issuer-directed priorities are established today. Alternatively, a merchant could delegate to its acquirer or processor the decision of how to route transactions.

One processor supported the proposed comment and urged the Board to further clarify that allowing more complex routing logic beyond network choice, such as basing a routing decision on the transaction amount, would be discretionary. Merchants did not oppose the proposed comment, but urged the Board to mandate that merchants be given additional information, including access to the BIN tables and the effective weighted average interchange

[167] *See* 75 FR 81752 (Dec. 28, 2010).

rates that are applicable to each merchant, at no cost, to facilitate merchants' ability to determine which networks are lower cost for purposes of directing routing.

Proposed comment 7(b)-3 is adopted with minor wording changes and redesignated as comment 7(b)-4 to the final rule. The comment clarifies that § 235.7(b) does not require that the merchant have the ability to select the payment card network over which to route or direct a particular electronic debit transaction at the time of the transaction. Thus, under the comment to the final rule, it would be sufficient for a merchant and its acquirer or processor to agree to a pre-determined set of routing choices that apply to all electronic debit transactions that are processed by the acquirer or processor on behalf of the merchant, or for the merchant to delegate the routing decisions to its acquirer or processor. The final rule does not specify criteria regarding the routing choices that must be provided to a merchant by its acquirer or processor because the Board believes such determinations are best left to the individual merchant's arrangement with its acquirer or processor. The final rule also does not require networks to make BIN tables or merchant-specific effective average interchange rates available to merchants as such a requirement is outside the scope of the statute. Nonetheless, the Board notes that, pursuant to EFTA Section 920(a)(3)(B), the Board intends to periodically publish the average interchange fee, by network, received by issuers, which may provide merchants information regarding relative interchange rates across networks.

One issuer commented that the Board should clarify that the payment card network that a merchant uses to process the initial purchase transaction for goods or services must also be used by the merchant for processing subsequent transactions related to the original purchase transaction. The Board has added new comment 7(b)-5 to clarify that the rule does not supersede

any network rule that requires the charge-back or return of a transaction to be processed over the same network as the original transaction.

### C. § 235.7(c) Effective Date

The network exclusivity rules in § 235.7(a) are generally effective and compliance is mandatory on April 1, 2012, with respect to issuers. With respect to payment card networks, however, the provisions in §§ 235.7(a)(1) and (a)(3) are effective on October 1, 2011. In addition, as described below, the effective date is delayed until April 1, 2013 for certain cards that use transaction qualification or substantiation systems. Non-reloadable general-use prepaid cards sold on or after April 1, 2013, must comply with the rule. Non-reloadable general-use prepaid cards sold prior to April 1, 2013, are not subject to the rule. Reloadable general-use prepaid cards sold on or after April 1, 2013, must comply with the rule. With respect to reloadable general-use prepaid cards sold and reloaded prior to April 1, 2013, the effective date is May 1, 2013. With respect to reloadable general-use prepaid cards sold prior to April 1, 2013, and reloaded after April 1, 2013, the effective date is 30 days after the date of reloading.

The merchant routing provisions of § 235.7(b) are effective on October 1, 2011. However, issuers and payment card networks may voluntarily comply with these rules prior to these dates.

#### 1. §§ 235.7(c)(1) and (c)(2) – General rule and effective date for payment card networks

The statute does not specify an effective date for the EFTA Section 920(b) provisions on network exclusivity and merchant routing restrictions. The Board requested comment on the appropriate implementation time for the network exclusivity and routing provisions given the different proposed alternatives under § 235.7(a). Specifically, the Board requested comment on

a potential effective date of October 1, 2011, for the provisions under § 235.7 if the Board were to adopt Alternative A under the network exclusivity provisions. Recognizing that Alternative B would require significantly more time to comply with the rule, the Board requested comment on an effective date of January 1, 2013, if Alternative B were adopted in the final rule.

Several issuers stated that the proposed effective dates did not allow sufficient time for compliance under either proposed alternative. With respect to Alternative A, issuers and some payment card networks requested longer lead times, generally until 2012 or 2013. Many such commenters observed that a significant number of issuers will be trying to add unaffiliated payment card networks at the same time to comply with the network exclusivity provisions in § 235.7(a). Consequently, these commenters were concerned that simultaneous efforts by numerous issuers will create a bottleneck at each network with respect to negotiating new membership agreements with the respective networks. These commenters urged the Board to provide additional time for compliance to allow for an orderly transition. Issuer commenters also noted that time would be needed for establishing connectivity with new payment card networks and for upgrading internal processing systems to support those networks. Some issuers, networks, and processors noted that the proposed time periods were also unrealistic from acquirers' perspective as they must implement the ability for individual merchants to designate customized transaction routing rules. Finally, networks and processors urged the Board to time any effective dates to coincide with regularly scheduled industry-wide changes.

By contrast, merchants, although recommending the adoption of Alternative B, urged the Board, if it adopted Alternative A, to make it effective promptly in order to void "exclusivity" deals currently in place. Merchants also expressed the view that there was little reason issuers could not comply with Alternative A for all debit cards by October 1, 2011, given that 70 percent

of debit cards already have dual functionality. Merchants also stated that Alternative A would not require issuers to reissue cards to meet the proposed timeframe, and that issuers could easily establish the necessary connectivity through their processors during that time. A member of Congress also commented that the proposed time periods for the alternatives were appropriate.

As discussed above, the final rule adopts Alternative A with respect to the network exclusivity provisions in § 235.7(a). Thus, an issuer generally could comply with the rule by enabling a signature debit network and an unaffiliated PIN debit network on its debit cards for processing an electronic debit transaction. Based on comments received and the Board's own outreach and analysis, the final rule in § 235.7(c)(1) states that, except as otherwise provided, the network exclusivity provisions in § 235.7(a) are effective for issuers on April 1, 2012.

Many issuers are already in compliance with the network exclusivity provisions in § 235.7(a) because they have multiple unaffiliated PIN networks enabled on their debit cards. Based on the Board's outreach, the Board understands that adding an additional PIN network can generally be accomplished in a matter of months where an issuer connects to a network through an issuer processor that has already established connectivity with other PIN networks. Thus, the Board believes that, in most cases, issuers would be able to comply with Alternative A by the October 1, 2011, date originally proposed. Nonetheless, to relieve the burden on issuers that may need more time to negotiate new agreements with networks, establish connectivity, and revise their internal processing systems to support the new networks, the final rule provides an additional six months to April 1, 2012, for compliance with the network exclusivity provisions in § 235.7(a).

The Board believes that issuers should have the opportunity to begin to comply with § 235.7(a) in advance of the effective date, irrespective of any existing network rules that would

prohibit them from adding an additional network to their debit cards. Therefore, in new § 235.7(c)(2), the Board is making the provisions of § 235.7(a) that are applicable to payment card networks effective on October 1, 2011. Accordingly, as of that date, a network may not enforce a rule that restricts the ability of an issuer to add a network to comply with § 235.7(a).

The final rule maintains the October 1, 2011, effective date for the merchant routing provisions in § 235.7(b). The earlier effective date is intended to allow merchants and acquirers to implement and exercise the new routing authority as soon as issuers make additional networks available on their debit cards. Thus, for transactions made using cards of issuers that comply with the network exclusivity provisions in § 235.7(a) prior to April 1, 2012, merchants will be able to take advantage of the new routing flexibility, assuming their acquirers update the BIN tables to reflect the new routing priorities preferred by the merchants.

**2. §§ 235.7(c)(3) and (c)(4) Delayed compliance date for certain debit cards**

The final rule also establishes a delayed compliance date for the network exclusivity provisions in § 235.7(a) in limited circumstances for certain types of debit cards that present technological or other operational impediments to an issuer's ability to comply with the rule. Although EFTA Section 920(b) does not provide the Board authority to exempt such debit cards from the network exclusivity provisions, the Board believes it is appropriate to establish a delayed compliance date of April 1, 2013, to allow issuers additional time to develop technological solutions to enable compliance with the rule. The effective date for the merchant routing provisions in § 235.7(b) would not be delayed for these cards to allow merchants to exercise routing choice once alternative networks are made available.

In the proposal, the Board noted that certain debit cards issued in connection with health flexible spending accounts and health reimbursement accounts are required by Internal Revenue

Service (IRS) rules to use certain technologies at the point of sale to ensure that the eligibility of a medical expense claim can be substantiated at the time of the transaction. The Board further stated its understanding, however, that PIN debit networks may not currently offer the functionality or capability to support the required technology. The Board recognized therefore that applying the network exclusivity prohibition to these health benefit cards in particular could require an issuer or plan administrator to add a second signature debit network to comply with IRS regulations if PIN networks were unable to add the necessary functionality to comply with those regulations. The Board requested comment on the appropriate treatment of these products with respect to the network exclusivity provisions in § 235.7(a).

Issuers and program administrators of health spending cards generally asserted that Congress did not intend to cover healthcare and employee benefit cards under any of the provisions in EFTA Section 920, even though the statute did not include a specific statutory exemption for such products. These commenters noted that the Inventory Information Approval System (IIAS) required by the IRS for auto-substantiating medical expenses for eligibility is not currently supported by the PIN networks. Thus, commenters expressed concern that the significant costs associated with either adding a second signature network or developing PIN network support for the IIAS could limit the viability of such card programs and cause employers and plan administrators to return to the inefficient system of using paper receipts to verify the eligibility of transactions. Commenters thus urged the Board to exempt cards linked to such health spending accounts from the network exclusivity and routing provisions.

Similar requests for exemption were made by commenters with respect to other employee benefit cards, such as cards used to provide transit benefits, which also require the use of specialized transaction qualification systems for verifying the eligibility of tax-exempt expenses.

For transit cards in particular, commenters also stated that the time required to enter a PIN ran counter to the processing-speed objective of the transit authorities.

Although EFTA Section 920 does not grant the Board authority to exempt cards linked to health spending accounts or other types of debit cards from the network exclusivity and routing provisions, the Board has determined there is good cause to delay the effective date of the network exclusivity provisions in § 235.7(a) to April 1, 2013 for debit cards that use point-of-sale transaction qualification or substantiation systems, such as the IIAS, to verify the eligibility of purchased goods or services in connection with health care and employee benefit accounts in accordance with IRS rules. *See* § 235.7(c)(3). The Board believes it is necessary to provide a longer compliance period for these cards to give PIN networks time to develop the capability to handle transactions using these cards or to give industry participants time to modify the manner in which signature debit routing is determined, so that these cards can be enabled on multiple signature debit networks.

Comment 7(c)-1 provides examples of debit cards that may qualify for the delayed effective date in connection with certain health care or employee benefit accounts. The comment clarifies that the delayed effective date for certain health care or employee benefit cards also applies to debit cards linked to health savings accounts that use transaction substantiation or qualification authorization systems at the point of sale, even if IRS rules do not require the use of such systems in connection with verifying the eligibility of expenses purchased with such cards. Although not specifically required by IRS rules, the Board understands that in virtually all cases health savings account cards use the same IIAS systems as do health flexible spending accounts and health reimbursement account cards to reduce the administrative burden for cardholders associated with sending in paper receipts for substantiating health-related expenses.

Several issuers and card program managers urged the Board to exempt non-reloadable gift cards from the network exclusivity provisions. These commenters noted that single-load prepaid cards typically run only on the signature debit networks, and that such products would be adversely affected by a requirement to enable or support PIN debit transactions. In particular, these commenters stated that the addition of a PIN debit network could require the consumer to call a service center to activate the card and obtain the PIN. By contrast, signature-only prepaid cards can be activated at the point of sale, and used immediately thereafter by the consumer. Commenters also stated that PIN access was unnecessary for single load cards that typically are depleted over a short period of time, and often after a single use.

Other issuer commenters urged the Board to exempt more broadly prepaid cards that are designed to only support a single method of authentication by a cardholder, whether such cards were reloadable or not. These commenters stated that many prepaid card programs do not have PIN capability in order to limit cash access by cardholders due to potential money laundering and other regulatory concerns. One depository institution trade association stated that for reloadable prepaid cards, the network exclusivity provisions should only apply to cards sold after October 1, 2013, to allow issuers to manage down their existing card inventories.

The Board believes it is appropriate to establish various delayed compliance dates for general-use prepaid cards to allow issuers time to develop the ability to enable cardholders to use PIN debit networks for prepaid card transactions or to give industry participants time to modify the manner in which signature debit transaction routing is determined, so that these cards can be enabled on multiple signature debit networks. Accordingly, the effective date for non-reloadable general-use prepaid cards is April 1, 2013. Non-reloadable general-use prepaid cards sold prior to the effective date are not subject to the requirements of § 235.7(a). The additional time is

intended to allow issuers to draw down existing card inventories, as well as to modify systems or develop solutions in order to comply with § 235.7(a). As noted above, single-load cards typically are depleted over a short period of time, and often after a single use. Instituting a PIN program for such cards in the short term would not seem to be beneficial as the cardholder would be unlikely to use the PIN option. Issuers of non-reloadable general-use prepaid cards commonly may not have the customer identification information that would be necessary to mail or otherwise provide the cardholder with PIN information. An alternate solution for non-reloadable cards is to add a second signature network, similar to prepaid cards with substantiation requirements. The delayed effective date provides issuers and payment card networks additional lead time before all prepaid cards must be capable of supporting more than one network for processing electronic debit transactions. Moreover, many of these cards already have been sold to customers and may be active through that date, and the issuer likely does not have the customer identification information necessary to provide the cardholder with a PIN. Application of these provisions to cards that have already been sold to customers who may not be known to the issuers may create difficulties for the issuers, as well as potential difficulties for the cardholders.

With respect to reloadable general-use prepaid cards, the effective date is April 1, 2013 (or later, in some circumstances), and all reloadable general-use prepaid cards sold on or after April 1, 2013, must be in compliance. Reloadable general-use prepaid cards share many of the problems as non-reloadable cards. However, PIN technology appears more prevalent with reloadable prepaid cards than with non-reloadable cards. The Board, therefore, anticipates that issuers of reloadable general-use prepaid cards are more likely to add an unaffiliated PIN network than another signature network to fulfill their obligations under § 235.7(a). Although

cardholders of reloadable prepaid cards may be provided a PIN at activation, commonly the issuer does not obtain customer identification information until the card is reloaded. Thus, for cards sold before April 1, 2013, an issuer may not have the ability to provide the cardholder with a PIN (if a PIN network is enabled) until the card is reloaded and the issuer obtains the necessary customer identification information to contact the cardholder. Accordingly, reloadable general-use prepaid cards sold prior to April 1, 2013, are not subject to § 235.7(a) unless and until they are reloaded. With respect to reloadable general-use prepaid cards that are sold and reloaded prior to April 1, 2013, the effective date is May 1, 2013. With respect to reloadable general-use prepaid cards sold prior to April 1, 2013, and reloaded after April 1, 2013, the effective date is 30 days after the date of reloading. The 30-day period is intended to ensure that issuers have sufficient time to provide card holders with information on the additional network, such as a PIN, after obtaining the necessary information to contact the card holder.

The final rule does not delay the effective date for the network exclusivity provisions for debit cards that are approved or issued for use on alternative or emerging payment card networks that do not require a cardholder's use of a signature or entry of a PIN to authenticate an electronic debit transaction. Issuers were divided regarding whether the network exclusivity and routing provisions should be applied to emerging payment systems. Payment card networks commenting on the issue were similarly divided on the issue.

Those commenters requesting exemptions from the network exclusivity and routing provisions expressed concern that the application of the rule would stifle innovation and reduce competition in the payments market. For example, commenters requesting an exemption for cards used on emerging payment systems stated that competing networks could refuse to add the emerging network's debit cards to limit competition. These commenters suggested that an

exemption for emerging payment systems would encourage investment in innovation and provide sufficient time for the nascent systems to conduct pilots and achieve scale. Merchants commenting on the issue agreed that it would be reasonable to permit new systems to undertake pilot programs until such time as they achieve critical mass.

By contrast, commenters that supported applying the network exclusivity and routing provisions to emerging payment systems stated that the rule should be equally applied to all networks to prevent an unlevel playing field. One such commenter stated that the Board's rule should apply based on whether an emerging payment system qualifies as a debit card or payment card network, regardless of whether it describes itself as a non-traditional or emerging network.

The purpose of the network exclusivity and routing provisions in EFTA Section 920(b) is to provide merchants with enhanced routing choice with respect to the networks available for processing an electronic debit transaction. In this regard, more, not fewer, networks would be desirable. As new technologies are being developed, the developers should take into consideration the provisions of EFTA Section 920(b). The Board believes that emerging payments technologies that meet the definition of "debit card" in the statute should not be subject to delayed effective dates for the network exclusivity and routing provisions.

## VII. § 235.8 Reporting requirements and record retention

### A. Summary of proposal and comments

The Board proposed to require issuers that are subject to §§ 235.3 and 235.4 and payment card networks to submit reports every two years, or more frequently as required, to the Board. Under the proposal, each entity required to submit a report must do so in a form prescribed by the Board and must provide information regarding costs incurred with respect to electronic debit transactions, interchange transaction fees, network fees, fraud-prevention costs, fraud losses, and

any other information requested by the Board. The Board proposed that it would publish, in its discretion, summary or aggregate information from these reports. The Board proposed that each entity required to submit the report to the Board by March 31 of the year the entity is required to report. Finally, the Board requested comment on a requirement that each entity required to report retain records of reports submitted to the Board for five years. Such entities also would be required to make each report available upon request to the Board or the entity's primary supervisors.

The Board received a few comments on the proposed reporting requirements. Some issuers commented that requiring issuers to report interchange fee revenue was duplicative, and therefore unnecessary, because networks already maintain records of each issuer's interchange fee revenue. A few commenters suggested the Board survey all interested stakeholders, including small issuers, merchants of all sizes, and consumers to determine the impact of the restrictions on them. One commenter suggested the Board establish a process for affected entities to inform the Board of significant changes to previously reported processing costs and other information.

The Board received one comment regarding the frequency of reporting in proposed § 235.8(c). One merchant commenter asserted that the word "bi-annual" in EFTA section 920(a)(3)(B) mandated reporting twice a year, whereas the Board proposed to require reporting biennially, or every two years. This commenter supported the more frequent, twice-a-year reporting in order to provide interested parties more visibility into the costs and fees received by issuer.

**B. Analysis and final rule**

EFTA Section 920(a)(3)(B) authorizes the Board to collect from issuers and payment card networks information that is necessary to carry out the provisions of Section 920(a). In addition, Section 920(a)(3)(B) requires the Board, in issuing rules on interchange fee standards and on at least a "bi-annual" basis thereafter, to publish summary or aggregate information about costs and interchange transaction fees as the Board considers appropriate and in the public interest. As summarized above in the debit card industry overview section of this notice, the Board has collected information from issuers and networks, as well as acquirers, and is publishing summary information about debit card transactions, processing costs, interchange fees, network fees, fraud-prevention costs, and fraud losses in connection with this final rule. More detailed summary information is available on the Board's website.[168]

**1. § 235.8(a) Entities required to report**

The Board has considered the comments regarding the entities from which the Board should collect information and has determined to adopt § 235.8(a) as proposed—limiting those entities required to report to issuers that are not otherwise exempt under § 235.5(a) and payment card networks, consistent with EFTA Section 920(a)(3). There are several other interested types of parties to debit card transactions, including, but not limited to, exempt issuers, acquirers, merchants, and cardholders. These other interested parties may or may not be able to provide information regarding costs, fees, fraud losses, volumes, and values associated with debit card transactions. However, EFTA Section 920 does not confer authority on the Board to compel all of these parties to provide information to the Board. EFTA Section 920(a)(3) authorizes the Board to require only issuers and payment card networks (and only as necessary to carry out the provisions of EFTA Section 920(a)) to provide information; this authority does not extend to merchants, cardholders, or others. Moreover, the Board is mindful of the large reporting burden

[168] http://www.federalreserve.gov/paymentsystems/files/debitfees_costs.pdf.

that could be imposed on exempt entities through a request that those entities isolate and track various debit card costs. The Board will continue to consider what, if any, additional information could be useful in assessing the effects of its final rule and how such information could be obtained with minimal burden on the relevant parties.

**2. § 235.8(b) Report**

Proposed § 235.8(b) set forth a non-exhaustive list of the information the Board may require entities to report, but did not specify which entities would be required to report which types of information. As stated in the proposal, the Board anticipates using forms derived from the Interchange Transaction Fee Surveys (FR 3062; OMB No. 7100).[169] At this time, the Board is not specifying the information that issuers and networks will be required to submit. Section 235.8(b)'s list of possible information required to be reported is intended to illustrate the kind of information the Board will require. The Board is making revisions to proposed § 235.8(b) to include information about transaction value, volume, and type, in part because the Board plans to request information from networks to monitor the extent to which they have adopted a two-tier interchange fee structure.[170] The Board intends to request comment on the reporting forms prior to the first report. At that time, the Board will consider whether collecting interchange fee revenue from both issuers and networks is necessary. Except for the revisions discussed in this paragraph, the Board is adopting § 235.8(b) as proposed.

**3. Section 235.8(c) Record retention**

The Board requested comment on a requirement that each entity required to report must retain records of reports submitted to the Board for five years. Such entities also would be required to make each report available upon request to the Board or the entity's primary

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[169] Copies of the survey forms are available on the Board's website at http://www.federalreserve.gov/newsevents/reform_meetings.htm.
[170] See discussion, above, in relation to § 235.5.

supervisors. The Board did not receive comments on this provision. Including a requirement that an issuer retain records to evidence compliance with the regulation is important to ensure that supervisory agencies have the information required to enforce the rule and to determine whether the entity has circumvented or evaded the interchange fee standard. However, specifying the precise form in which such evidence must be maintained is unnecessary. The issuer and its primary supervisor can determine in what form records must be retained to demonstrate compliance, so long as the information is retrievable and useable by the agencies.

To minimize the burden on issuers to retain information after the issuer's supervisor has examined the issuer for compliance, the Board is adopting § 235.8(c) to require issuers to retain records that demonstrate compliance with the requirements of part 235 for not less than five years after the end of the calendar year in which the electronic debit transaction occurred. For example, for an electronic debit transaction that occurred on March 1, 2012, an issuer must maintain records demonstrating compliance with the requirements of this part through December 31, 2017. The issuer's primary regulator, however, may determine that a longer record retention period is warranted. *See* § 235.9. Section 235.8(c)(2) sets forth an exception to the general rule—if an issuer receives actual notice that it is subject to an investigation by an enforcement agency, the issuer shall retain the records until final disposition of the matter unless an earlier time is allowed by court or agency order.

**4. Submission timeframe and frequency**

The Board proposed to require issuers that are subject to §§ 235.3 and 235.4 and payment card networks to submit reports to the Board every two years. The Board requested comment, under proposed § 235.8(c), on reserving discretion to require more frequent reporting. The Board proposed that entities required to report submit the report to the Board by March 31

of the year they are required to report in order to provide a reasonable time to compile the data necessary to complete the report.

The Board did not receive comments explicitly regarding the submission timeframe of required reporting, but did receive a few comments on a similar provision—issuer submission of cost information to networks under proposed Alternative 1. In relation to that provision, commenters, although not necessarily supporting Board-required certification, supported a March 31 deadline for submission if adopted by the Board. The Board, however, has determined not to mandate a specific date in the regulatory text in order to retain flexibility to adjust the reporting deadline or the reporting period to provide an appropriate period of time for institutions to respond. Accordingly, the Board is not adopting in its final rule proposed § 235.8(c). Rather, similar to other reports the Board requires to be filed, the instructions to the report will indicate when the report is due.

The Board also expects initially to require different reporting frequencies for issuers and payment card networks. As discussed above in relation to § 235.5, the Board plans to gather information from networks regarding their interchange fee structures on an annual basis and from covered issuers regarding their costs every two years.

The statute requires the Board to disclose aggregate or summary information concerning costs and fees on at least a biannual basis. "Biannual" can mean either twice a year or every two years.[171] The Board believes it is appropriate to interpret "biannual" as meaning every two years in the context of the statute's disclosure provision, given the substantial reporting burden involved in collecting the issuer cost data. More frequent reporting by networks or issuers may be warranted in the future, depending on what the data collected and other industry practices

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[171] *See Merriam-Webster's Collegiate Dictionary* (10th edition) defining "biannual" as meaning "twice a year" or "biennial," which in turn is defined as occurring every two years.

reveal. Accordingly, the Board is not specifying the frequency of required reporting in the regulatory text in order to retain flexibility. Similar to other reporting forms, the Board plans to indicate with publication of the form the frequency with which entities are required to report.

Additionally, the Board is deleting proposed § 235.8(d), which stated that the Board may, in its discretion, disclose aggregate or summary information reported. This provision was a restatement of the Board's statutory authority to disclose such information under EFTA Section 920(a)(3) and is not necessary.

## VIII. Section 235.9 Administrative enforcement

EFTA Section 920(d) provides that the requirements of EFTA Section 920 may be enforced by the relevant Federal administrative agencies in accordance with EFTA Section 918. Proposed § 235.9 set forth the agencies that may enforce compliance with part 235. The Board received no comments explicitly on proposed § 235.9, but received comments from some merchants urging the Board to require *ex post* verification by supervisors of issuer compliance with the fee standards and to enumerate penalties for failure to comply.[172] Any penalties for non-compliance are subject to the discretion of an issuer's or a network's primary supervisor. Accordingly, the Board has not set forth penalties for non-compliance with this part. The Board received no other comments on proposed § 235.9 and has determined to adopt § 235.9 as proposed.

## IX. Section 235.10 Effective Date

[172] The Board received one comment suggesting a mechanism for enforcing compliance with a proposed network-average interchange fee approach. The Board has determined not to adopt a network-average approach to the interchange fee standards and, therefore, need not address the suggested approach to enforcement.

Except as provided in § 235.7 (discussed above), the provisions of this final rule are effective and compliance is mandatory beginning October 1, 2011.[173] Issuers may voluntarily comply with these provisions prior to that date.

The Board proposed that the interchange fee standards would be effective on July 21, 2011, coinciding with the effective date of EFTA Section 920(a) (set forth in EFTA Section 920(a)(9)). The Board received numerous comments regarding the effective date of the interchange fee standards, many of which urged the Board to delay the rule's effective date.

Several issuers and networks expressed concern that the proposed effective date would not allow sufficient time to make necessary system changes, under either of the proposed fee standard alternatives. For example, one processor stated that, currently, there is no interchange-fee data field transmitted with the transaction data at the time the acquirer or processor makes the routing decision. This commenter contended that networks should be responsible for identifying the specific interchange fee category to ensure merchants have interchange fee information available at the time of the routing decision. Many of these commenters suggested a phased-in approach of the new standards to mitigate the impact of the standards on market participants. A few issuers and networks suggested that the Board deem current interchange rates to comply with the "reasonable and proportional" requirement for some period of time until the industry can implement new standards (i.e., one to two years). A few issuers suggested the Board, in addition to adopting a rule with a higher safe harbor and/or cap, study the impact of both the interchange fee standards and exclusivity and routing provisions prior to adjusting the safe harbor and/or cap.

[173] Section 235.4 and accompanying definitions, which are added by the interim final rule published separately in the *Federal Register*, also are effective on October 1, 2011.

Numerous issuers and networks contended that an issuer-specific standard would take longer to implement than a cap because networks and issuers would need to time to calculate their allowable costs and networks would need time to establish a process for obtaining this information, to write and implement new network rules, and to work with issuers, acquirers, processors, and merchants to implement the new interchange fee structure. A few commenters suggested specific compliance dates if the Board implemented proposed Alternative 2. The earliest suggested date was April 2012. More commonly, commenters suggested an effective date of one year from publication, with other commenters suggesting that implementation could not be accomplished until well after July 2013. One issuer suggested that July 2013 would permit networks to develop two-tier interchange fee structures. Irrespective of the actual effective date, one commenter suggested a mid-month effective date for changes to the interchange fees to align with current network processes designed to reduce the financial risk of month-end and quarter-end processing.

The Dodd-Frank Act does not specifically provide an effective date for the Board's rules implementing EFTA Section 920(a). The Board is directed to issue final regulations within nine months of the Dodd-Frank Act's enactment, and EFTA Section 920(a) is effective one year after enactment, indicating that Congress intended at least a three-month implementation period before the interchange fee standards become effective. Moreover, the final rule requires significant changes to existing interchange fee practices and systems changes by issuers and payment card networks. An October 1 effective date also coincides with the normal schedule for many network releases of systems changes. Additionally, the Congressional Review Act dictates that the Board's final rule—as a major rule—cannot be enforced until the end of a 60-day

Congressional review period following transmission of the final rule to Congress.[174] For these reasons, the Board believes that an October 1, 2011 effective date balances Congress's directions of prompt effectiveness and sufficient time for congressional review and for issuers and payment networks to bring their systems and practices into compliance. The effective date for the provisions implementing the routing and exclusivity requirements of EFTA Section 920(b) are discussed above in connection with the explanation of the requirements of § 235.7.

**Effects of the rule on various parties**

**I. Overview of comments received**

Comments from issuers, merchants, payment card networks, and consumers addressed the benefits and drawbacks of the current system, the impact of EFTA Section 920 and the effect of the Board's proposed rule on various parties and on the current system overall, and alternatives to the proposed rule. Numerous commenters (primarily issuers, networks, and some consumer representatives) stated that the current interchange fee system has resulted in the development of a payment system that provides significant benefits for merchants, consumers, and issuers. Many of these commenters stated that merchants should pay for the benefits they receive from accepting debit cards, which they said included cost savings relative to accepting cash, checks, or credit cards; faster check-out at the point of sale; higher consumer spending; guaranteed payment; avoiding liability for most fraudulent transactions; faster settlement; secure online transactions; and less time and money spent on collections, billing, and other administrative matters. Other commenters stated that the debit card system enables small merchants to compete with larger merchants.

Merchant commenters, by contrast, objected to the current interchange fee system, noting that although transactions processing costs have fallen substantially, interchange fees have not.

[174] *See* 5 U.S.C. 801.

These commenters also noted that merchants often do not know at the time of purchase the amount of the interchange fee that will be assessed on a transaction. In addition, many merchants objected to networks setting interchange fees centrally for all participating issuers, noting that these centrally determined fees bear no relation to the costs of individual issuers.

Merchant commenters explained that high interchange fees force them either to accept lower gross margins, raise prices charged to their customers, or reduce other costs. These commenters stated that, as a practical matter, they cannot discontinue acceptance of debit cards because of their widespread adoption by consumers. By contrast, numerous non-merchant commenters asserted that merchants that are unhappy with current interchange fee levels could stop accepting debit cards as a form of payment or could negotiate with networks and acquirers for lower interchange fees and merchant discounts. Some of these commenters noted that merchants are able to offer cash discounts in order to encourage payment by other means. Some merchant commenters, however, stated that offering cash discounts was impractical.[175]

Numerous commenters recognized that consumers benefit from debit cards. Specifically, these commenters asserted that debit cards provide consumers with a widely accepted payment method, increased security (by reducing fraud liability and the risk associated with carrying cash), and increased convenience (by reducing the need to carry cash). Several of these commenters stated that the current interchange fee system benefits consumers through lower fees for accounts and banking services, as well as rewards for debit card purchases. By contrast, several merchants stated that consumers pay higher retail prices as a result of merchants passing on the cost of interchange fees.

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[175] Several merchant commenters also objected to certain other practices, such as processors offering low rates for an introductory period only, imposing hidden fees, and delaying availability of funds by an extra day if the merchant routes the transaction through a PIN-debit network. One merchant commenter stated that because EFTA Section 920(b)(2) does not restrict the ability of a payment card network to prohibit differential pricing on the basis of the network used, networks would not have sufficient incentives to reduce fees borne by merchants.

Commenters also stated that issuers receive benefits from debit cards, including interchange fee revenue. Several commenters stated that issuers use interchange revenue to cover operating costs and offset fraud losses. Other commenters noted additional benefits that debit cards provide for issuers. For example, these commenters asserted that debit cards provide a means for issuers to establish an account relationship with customers, to reduce the need for issuers to hold cash (and to maintain expensive brick-and-mortar branches in order to facilitate withdrawals), and to experience cost savings from processing fewer checks. By contrast, one issuer stated that debit card transactions are more expensive to process than checks due to processing fees, cost of inquiries and disputes, and fraud losses.

Numerous commenters asserted that the Board's proposed rule would have adverse, unintended consequences on issuers, consumers, payment card networks, and the payment system more generally. A few commenters asserted that the Board's proposed rule would negatively impact small merchants as well. Many of these commenters stated that the Board's proposed rule should have included a competitive-impact analysis required by EFTA Section 904(a) that was performed in accordance with the Board's competitive-impact analysis bulletin.

## II. Effects on consumers

### A. Comments received

A number of commenters, primarily issuers and networks, asserted that consumers would be harmed by the proposed rule, contrary to the statutory intent. They predicted that the substantial reduction in interchange fee revenue resulting from the proposed rule would lead card issuers to raise fees charged to deposit account customers, reduce benefits for users of debit cards (e.g., rewards or liability protections), not authorize the use of debit cards for high-risk or high-value transactions, or restrict or eliminate the issuance of debit cards. These commenters argued

that low income consumers would likely experience the greatest harm, as they would be unable or unwilling to incur the higher costs associated with maintaining deposit accounts, and may consequently be forced out of the banking system.

At the same time, these commenters asserted that consumers would not experience any benefits from lower interchange fees because they expect that merchants would not reduce prices charged to consumers, given that there is no statutory requirement for them to do so.[176] They viewed the reduction in interchange fees as a transfer of revenue from card-issuing banks to merchants, with no benefit flowing to consumers.

In addition, some commenters argued that the exclusivity and routing provisions would adversely affect consumers by eliminating the ability of cardholders to ensure that a transaction was routed over a network that provides certain benefits to its cardholders. In particular, these commenters noted that certain cardholder benefits, such as zero liability, enhanced chargeback rights, rewards, or insurance, are often tied to the use of a particular network. In their view, requiring unaffiliated networks on a card with merchant control of routing would make it less likely that a cardholder would receive those benefits if a merchant opted to route a transaction over the merchant's preferred network.

Other commenters, primarily merchants and some consumer groups, asserted that consumers would benefit from the proposed rule. Several commenters indicated that, currently, the cost of interchange fees is being passed on to consumers through higher retail prices, and therefore consumers would benefit from a reduction in the interchange fees. They argued that merchants would have no choice but to pass on their cost savings to consumers, given the

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[176] In support of their contentions, these commenters pointed to the experience of other countries with regulating interchange fees, most notably Australia and Canada. Issuers and some consumers asserted that interchange fee regulation in other countries demonstrates that merchants will not pass on savings to consumers at the point of sale and that issuers will increase per-transaction fees or other account fees.

competitive environment in which they operate. They further argued that low income consumers, who are currently less likely to use debit cards, would experience the greatest benefits from lower prices at the point of sale. Some commenters suggested that lower interchange fees could enable merchants to enhance their operations through, for example, more stores or improved customer service, which would benefit consumers. In addition, they questioned the claim that lower interchange fees would lead to higher account fees for deposit customers, noting that over the past decade both interchange fees and other bank fees have increased sharply.

**B. Analysis**

The ultimate net effect of the final rule on consumers will depend on the behavior of various participants in the debit card networks. A reduction in interchange fees would likely lead to a decrease in merchants' costs of debit card acceptance, which could be passed on to consumers in the form of lower prices. Merchants operating in highly competitive markets with low margins are likely to pass the bulk of these savings on to consumers, while merchants operating in less competitive markets may retain a greater portion of the savings. Thus, other things equal, the Board expects the rule to result in some reduction in prices for goods and services faced by consumers.[177] However, if issuers encourage consumers to shift from debit cards to credit cards, which are more costly to merchants, overall merchant costs could rise, despite a reduction in the cost of accepting debit cards, and these higher costs could be passed on to consumers. If merchants continue their current practice of not varying their prices with the

[177] It is not practical, however, to measure the extent to which lower interchange fees translate into lower merchant prices, because of the many other factors that also influence those prices. Australia has the longest experience with government limits on interchange fees. Although the Reserve Bank of Australia acknowledges the difficulties involved in measuring the effect of the interchange fee reductions on merchant prices, it has stated that it is confident that savings are passed through to consumers, given that in a competitive market, changes in merchants' costs are generally reflected in the prices that merchants charge. *See* http://www.rba.gov.au/payments-system/reforms/review-card-reforms/review-0708-pre-conclusions/index.html

form of payment, any benefits associated with price reductions, or costs associated with price increases, would likely accrue to all consumers, regardless of whether they use debit cards. In addition, lower debit card interchange fees would likely provide merchants that currently do not accept debit cards with a greater economic incentive to do so, which may benefit consumers by increasing their ability to use debit cards.

At the same time, covered issuers are likely to implement some changes in response to the reduction in interchange fee revenue. They may seek alternative sources of revenue, including higher fees from debit card users or deposit account customers more generally, or may reduce or eliminate debit card rewards programs. In addition, card issuers may look for opportunities to reduce operating costs, which could involve reducing benefits associated with deposit accounts or debit cards.

Finally, the exclusivity and routing provisions of the final rule may limit the ability of cardholders to determine the network over which a transaction is routed and, thus, may limit their ability to ensure that they receive benefits associated with certain networks. Currently, however, consumers are typically unaware of the network used to route PIN debit transactions in situations where multiple PIN networks are enabled on their cards. Therefore, the effect on consumers of merchant routing decisions in such situations may be minimal. Moreover, under the final rule, which does not require multiple unaffiliated networks for each method of authentication, consumers may still be able to influence transaction routing through their choice of authentication method.

Thus, the effect of the rule on any individual consumer will depend on a variety of factors, including the consumer’s current payment behavior (e.g., cash user or debit card user), changes in the consumer’s payment behavior, the competitiveness of the merchants from which

the consumer makes purchases, changes in merchant payment method acceptance, and changes in the behavior of banks.

## III. Effects on Issuers

### A. Comments received

Numerous commenters discussed the anticipated effect of the proposed rule on covered and exempt issuers; some commenters predicted that any adverse impact would be minimal, whereas other commenters predicted that the adverse impact would be far more severe. More specifically, merchant commenters believed that reducing interchange fees would not have a significant adverse impact on issuers' profits (noting that issuers were profitable before they received interchange revenue); they also questioned claims that issuers would reduce debit card issuance, because they believe debit cards are a lower-cost means of access to deposit account funds compared with checks.

Numerous issuer commenters stated that the proposed rule's substantial reduction in interchange fee revenue would adversely affect debit card programs. Many of these issuers stated that debit cards have become an essential tool for consumers; therefore, not offering debit cards is not an option. Issuers were concerned that a substantial drop in interchange fees would adversely affect their financial condition and raise safety and soundness concerns. A few issuers noted that the proposed rule's adverse impact would be particularly burdensome in light of the recent financial crisis and recent regulatory changes, including the repeal of the prohibition on paying interest on demand deposits, limitations on overdraft fees, and increases in deposit insurance fund premiums. Specifically, these issuers were concerned that they would be unable to earn sufficient revenue to attract capital and continue to invest in fraud prevention, processing, and other technologies.

Numerous issuers indicated that, if the Board adopted its proposal, they may impose or raise debit card or other account fees, decrease cardholder rewards and other benefits including interest, decrease the availability of debit cards and other banking services (by, for example, imposing debit card transaction size limits), or reduce the scale of their operations. Some consumer group commenters argued that, because covered issuers would simply raise other fees to make up for lost interchange revenue, the proposed rule would have little or no effect on covered issuers. Some issuer commenters asserted, however, that they would not be able to recoup all of the lost interchange fee revenue through other customer fees, and therefore would need to scale back their debit card programs. One issuer claimed that the combination of higher customer fees and reduced program benefits would put covered issuers at a competitive disadvantage relative to exempt issuers.

Numerous commenters (predominantly issuers) noted that interchange fee revenue currently is used to offset fraud losses absorbed by issuers, particularly those related to signature debit transactions. Several of these commenters asserted that most of the losses result from action (or lack of action) on the merchant side of transactions. Merchant commenters, by contrast, believed it was unfair for merchants to pay for fraud losses that could be avoided through use of PIN debit transactions. In addition, merchants argued that issuer incentives to card holders to choose signature debit over PIN debit would be diminished if fraud losses were not compensated through interchange fees. In general, however, commenters disagreed on the allocation of fraud losses between merchants/acquirers and issuers.[178]

As provided by the statute, issuers with consolidated assets of less than $10 billion are exempt from the rule's interchange fee standards, but not from the network exclusivity and

[178] For example, some issuers assert they cannot charge back some fraudulent transactions even when a merchant does not follow network rules. Other commenters assert that it is difficult for merchants to prove they followed correct procedures, and therefore merchants bear much of the loss.

routing provisions. Some commenters, primarily issuers and smaller networks, argued that issuers that are exempt from the interchange fee standards would be harmed by the proposed rule because either (i) the exemption would not be effective, and exempt issuers would face reductions in interchange fees that are similar to those required for covered issuers; or (ii) the exemption would be effective, and merchants would discriminate against the higher-cost cards issued by exempt banks. These commenters believed that the exemption might not be effective because networks are not required to establish separate interchange fee schedules for exempt and covered issuers. Furthermore, they asserted that even if networks did establish separate schedules, market forces would put downward pressure on exempt issuers' interchange fees. In part, these commenters argued that this downward pressure on interchange fees would result from the prohibition on network exclusivity and routing restrictions, which would allow merchants to route transactions over networks with lower interchange fees. In addition, some of these commenters expressed concern that the proposed rule's requirement for at least two unaffiliated networks on a card would result in increased costs for issuers that are exempt from the interchange fee standards. Some commenters asserted that the harm to small issuers might be sufficient to cause some of them to fail. Some exempt issuers stated that they did not believe they would be able to replace lost revenue as readily as covered issuers because they have less diversified product lines than covered issuers.

Merchant commenters argued that issuers that are exempt from the interchange fee standards would not be harmed by the proposed rule. They argued that the exemption would be effective, noting that several networks have already indicated their intent to establish separate interchange fee schedules for covered and exempt issuers. They also dismissed the idea that merchants might discriminate against exempt issuers' cards, arguing that (i) merchants cannot

practically implement such discriminatory practices and have an incentive to avoid alienating customers who hold cards issued by exempt issuers, and (ii) networks have rules requiring a merchant that accepts any of a network's debit cards to accept all of that network's debit cards, regardless of issuer.

**B. Analysis**

It is not clear how covered issuers will respond to the reduction in interchange revenue. Experience in other countries has shown that the extent of debit card usage is not necessarily related to the level of interchange revenue received by issuers.[179] Issuers may need to provide debit cards on attractive terms in order to attract and retain consumer transaction account balances. Covered issuers may offset some or all lost interchange fee revenue through a combination of customer fee increases (although competitive forces may limit their practical ability to do so), reductions in debit card rewards programs, and cost reductions.

It is difficult to predict the market response to the rule, and thus the likely overall effect of the rule on exempt issuers. Both the statute and the final rule permit, but do not require, networks to establish higher interchange fees for exempt issuers than would be allowable for covered issuers. Networks that collectively process about 80 percent of debit card volume have indicated that they will establish two separate interchange fee schedules when the rule goes into effect. These plans likely reflect the incentives networks have to attract and retain small issuers, which the Board estimates account for roughly 30 percent of debit card transaction volume. Networks will likely review the appropriateness of their interchange fee structures and levels over time as the competitive landscape continues to evolve.

To the extent that two-tier pricing is adopted by the networks, the Board believes that it is unlikely that merchants would discriminate against exempt issuers' cards. First, it would not

[179] In Canada, for example, debit card usage is widespread, despite the absence of an interchange fee.

appear to be in a merchant's interest to steer customers away from using an exempt issuer's debit card, because the cardholder will often not have a payment option that is more attractive to the merchant. Although some merchants have been known to steer customers who present a high-cost credit card to a lower-cost credit card, they have been able to do so because consumers often carry multiple credit cards. That is generally not the case with debit cards; consumers typically have only one checking account and hence one debit card. Merchants would have no incentive to steer customers to pay by credit card, because credit card payments generally involve a higher cost to merchants than do debit card payments. Moreover, given that fewer and fewer consumers carry checks or large amounts of cash, merchants risk losing the sale entirely if they attempt to steer customers away from exempt issuers' debit cards and towards non-card methods of payment.

In addition, as noted by some commenters, network rules prohibit such discrimination. For example, the honor-all-cards rules of the networks require a merchant that accepts a network's debit cards to accept all of that network's debit cards, regardless of the issuer. Moreover, although EFTA Section 920(b)(2) provides that a payment card network cannot restrict merchant discounts across methods of payment, it does not limit a network's ability to prohibit discounts on the basis of the issuer.

The network exclusivity and routing provisions, however, which by statute apply to issuers that are exempt from the interchange fee standards, may lead to higher costs for some exempt issuers. Moreover, these provisions could put some downward pressure on interchange fees overall if merchants are able to route transactions over lower-cost networks. The ultimate effect of any downward pressure on interchange fees due to the network exclusivity and routing provisions depends on the industry response once those provisions are in effect. Thus, it is

possible that, even with two-tier interchange fee schedules, some issuers that are exempt from the interchange fee standard may receive less interchange revenue than they would have absent the rule. The Board expects, however, that even if interchange fee revenue received by small issuers declines, it will remain above the level they would have received if they were not exempt from the interchange fee standard.

As discussed above, the Board is taking several steps to mitigate any adverse effect on small issuers. First, it will publish lists of institutions that fall above and below the small issuer exemption asset threshold, to assist payment card networks in determining which of the issuers participating in their networks are subject to the rule's interchange fee standards, and plans to update these lists annually. In addition, the Board plans to survey payment card issuers annually and publish a list of the average interchange fee that each network provides to its covered issuers and to its exempt issuers.[180] This list should enable issuers, including small issuers, to more readily compare the interchange revenue they would receive from each network.

## IV. Effects on merchants

### A. Comments received

Some commenters, primarily issuers and networks, expected that merchants would benefit from the rule, as they would face lower costs associated with debit card acceptance and would not pass these savings on to consumers. In addition, they argued that the exclusivity and routing provisions, which give merchants the ability to direct their transactions over the lower-cost network, may further benefit merchants. However, some of these commenters argued that small and medium-sized merchants may be harmed, as their acquirers would not necessarily pass on the benefits of lower interchange fees to them, whereas large merchants, which have more

[180] Under EFTA Section 920(a)(3)(B), the Board may require any issuer or payment card network to provide the Board with such information as may be necessary to carry out the provisions of EFTA Section 920(a).

bargaining power in dealing with their acquirers, would benefit from lower interchange fees and would thereby gain a competitive advantage relative to smaller merchants.

Merchants generally expected the proposed rule to result in significant merchant cost savings, which, they argued, could be the difference between staying in business and going out of business. Merchant commenters supported the proposed rule's cost-based interchange fees and indicated that the rule would increase competition among payment card networks, improve pricing transparency, and increase innovations by merchants. Merchants also noted that cost savings could translate into increased hiring, more stores, or other enhancements, such as improved customer service. However, one merchant group was concerned that merchants with a high proportion of small-ticket transactions may stop accepting debit cards because the interchange fees for these types of transactions could increase under the proposed rule.

A few commenters were skeptical that competition from the network routing provisions would place material downward pressure on interchange fees. Some commenters expect issuers to promote use of credit cards over debit cards, which could result in higher costs for merchants due to higher credit card interchange fees.

**B. Analysis**

As noted above, merchants that operate in highly competitive markets with low margins are likely to pass on most or all of the interchange cost savings to their customers in the form of lower prices or improved service; by contrast, merchants that operate in less competitive markets may retain a greater portion of the interchange fee savings. The merchant-acquiring business, broadly speaking, is competitive; therefore, the Board believes that acquirers would pass on the savings from lower interchange fees to their merchant customers, regardless of merchant size. Consequently, the Board does not believe that the rule would adversely affect small and

medium-sized merchants.[181] Although it is possible that merchants with a large proportion of small-ticket transactions may experience an increase in total interchange fees, the rule does not require networks to raise the current interchange fees for very-small-value transactions.

## V. Effects on other parties

### A. Comments received

Many issuer and network commenters stated that the proposed rule's reduction in interchange fee revenue would adversely affect payment card networks, as well as the payment system more generally.[182] These commenters stated that the proposed interchange fee levels would erode the current beneficial characteristics of debit cards and stifle future innovation in the debit card industry (including the introduction of alternative payment systems). These commenters also stated that the proposal would lead to fewer payment options for consumers because issuers would stop offering debit cards (leading to increased reliance on cash and checks), promote the use of credit cards, or both. Promoting the use of credit cards, these commenters asserted, would adversely affect consumers because credit cards do not have the same debt-management characteristics as debit cards. Other commenters asserted that increased reliance on cash and checks would result in greater money laundering and tax compliance risks. By contrast, several merchants stated that a reduction in interchange fees would benefit the payment system by increasing merchant acceptance of debit cards (which have beneficial debt management characteristics).

### B. Analysis

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[181] Certain small and medium-sized merchants that have entered into long-term contracts with independent resellers of payment card services may experience some delay before realizing lower transaction costs.
[182] Some issuer and network commenters believe that interchange fee restrictions are unfair because financial institutions and networks invested in building the current network infrastructure. In contrast, some merchant commenters asserted that issuers and networks have already been more than compensated for historical investment in the debit card system. Another commenter stated that reduced interchange fee revenues would increase the cost of leasing point-of-sale terminals.

The effect of the rule on payment card networks and the payment system more generally will depend on the market responses to the rule by the various payment system participants. Based on experiences in other countries that have adopted interchange fee regulations, the Board does not expect a significant shift away from debit card payments or any meaningful degradation of the integrity of the payment system. The provisions prohibiting network exclusivity and routing restrictions could spur competition among payment card networks, which may have an overall positive effect on payment system efficiency.

**EFTA 904(a) Economic Analysis**

**I. Statutory requirement**

Section 904(a)(2) of the EFTA requires the Board to prepare an economic analysis of the impact of the regulation that considers the costs and benefits to financial institutions, consumers, and other users of electronic fund transfers. The analysis must address the extent to which additional paperwork would be required, the effect upon competition in the provision of electronic fund transfer services among large and small financial institutions, and the availability of such services to different classes of consumers, particularly low income consumers.

**II. Cost/benefit analysis**

The **Section-by-Section Analysis** above, as well as the **Final Regulatory Flexibility Analysis** and **Paperwork Reduction Act** analysis below, contain a more detailed discussion of the costs and benefits of various aspects of the proposal. This discussion is incorporated by reference in this section.

As required by Section 920 of the EFTA (15 U.S.C. 1693o-2), the final rule, which the Board is implementing in Regulation II, establishes standards for assessing whether an interchange transaction fee received or charged by an issuer (and charged to the acquirer) is

reasonable and proportional to the cost incurred by the issuer with respect to the transaction. Specifically, the final rule provides that an issuer may not receive or charge an interchange transaction fee in excess of the sum of a 21-cent base component and 5 basis points of the transaction's value (the *ad valorem* component).

Certain issuers and products are exempt from the interchange fee restrictions, including small issuers that, together with their affiliates, have less than $10 billion in assets; certain cards accessing government-administered payment programs; and certain reloadable general-use prepaid cards that are not marketed or labeled as a gift certificate or gift card. Payment card networks may, but are not required to, differentiate between interchange fees received by covered issuers and products versus exempt issuers and products.

Regulation II also prohibits issuers and payment card networks from both restricting the number of payment card networks over which an electronic debit transaction may be processed to fewer than two unaffiliated networks and inhibiting the ability of a merchant to direct the routing of an electronic debit transaction over any payment card network that may process such transactions. Under the final rule, issuers are required to have at least two unaffiliated payment card networks for each debit card they issue.

**A. Additional paperwork**

Under the final rule, issuers that do not qualify for the small issuer exemption would be required to provide cost data to the Board. Covered issuers would also be required to retain records that demonstrate compliance with the requirements of Regulation II for not less than five years after the end of the calendar year in which the electronic debit transaction occurred. If an issuer receives actual notice that it is subject to an investigation by an enforcement agency, the issuer must retain the records until final disposition of the matter.

In addition, under the Interim Final Rule, published separately in the *Federal Register*, issuers are required to develop, implement, and update policies and procedures reasonably designed to (i) identify and prevent fraudulent electronic debit transactions; (ii) monitor the incidence of, reimbursements received for, and losses incurred from fraudulent electronic debit transactions; (iii) respond appropriately to suspicious electronic debit transactions so as to limit the fraud losses that may occur and prevent the occurrence of future fraudulent electronic debit transactions; and (iv) secure debit card and cardholder data. If an issuer meets these standards and wishes to receive the adjustment, it must certify its eligibility to receive the fraud-prevention adjustment to the payment card networks in which the issuer participates.

For smaller institutions that are not required to submit cost information to the Board under Regulation II, the regulation does not impose any reporting requirements. However, it is possible small issuers may have reporting requirements to payment card networks to certify their exempt status. As discussed above, for those networks that choose to implement a two-tier interchange fee structure that provides different interchange rates to larger issuers and exempt small issuers, the Board plans to publish annually lists of institutions above and below the small issuer exemption asset threshold. If a payment card network decides to distinguish between large and small issuers, small issuers that are not on the Board's list of institutions that, together with their affiliates, have less than $10 billion in assets may need to provide information to the network in order to take advantage of the exempt fee structure.

**B. Competition in the provision of services among financial institutions**

As discussed in "Effects of the rule on various parties" above, numerous commenters discussed the anticipated effect of the proposed rule on covered and exempt issuers. The Board understands that payment card networks that together process about 80 percent of debit card

transaction volume have indicated their intent to establish two-tier interchange fee structures. To the extent payment card networks do not establish different interchange fee schedules for exempt and covered issuers, exempt issuers that participate in these networks will experience a decline in their interchange transaction fees, for transactions routed over these networks, similar in magnitude to that experienced by covered issuers. If exempt issuers have higher costs for debit card transactions than do covered issuers, this decline in interchange revenue may necessitate a larger adjustment of fees or other account terms by exempt issuers than by covered issuers. In addition, if exempt issuers typically offer narrower product or service lines than covered issuers, as suggested by some issuer commenters, then exempt issuers may adjust fees and account terms that are closely tied to their debit card operations or deposit accounts, whereas covered issuers may also modify fees and terms for other complementary or substitute products, such as credit cards, offered by those issuers. Under a scenario in which some networks do not establish different interchange fee schedules for exempt and covered issuers, resulting disparate changes in account fees or terms might cause a shift of deposit customers from exempt to covered issuers.

To the extent payment card networks do establish two-tier fee structures, covered issuers will likely experience a greater decline in their interchange revenue compared to exempt issuers. In such a situation, covered issuers may need to adjust fees and account terms in response to the lower interchange revenue, whereas exempt issuers may not. Under this scenario, consumers may shift their purchases of some financial services from covered issuers to exempt issuers in response to changes in fees and account terms at covered issuers. However, covered issuers with diversified product lines may look to retain customers by promoting alternative products not covered by the interchange fee standards, such as credit cards.

Regardless of whether or not networks establish two-tier fee structures, the competitive effects of any changes in fees or account terms across covered and exempt issuers due to a decline in interchange revenue will depend on the degree of substitution between small, exempt issuers and large, covered issuers. If the cross-price elasticity between exempt and covered issuers is large, then substantial shifts in market share may occur in response to disproportionate changes in fees and account terms by exempt versus covered issuers. Conversely, if substitution between exempt and covered issuers is low, then any changes in fees and account terms by exempt versus covered issuers may generate small shifts in market shares across exempt and covered issuers.

As the previous analysis suggests, the effect on competition among large and small financial institutions will depend on a number of factors, including the extent to which payment card networks implement and retain two-tier fee structures, the differentials in fees across tiers in such structures, the product and service lines offered by large and small financial institutions, and the substitutability of products and services across large and small financial institutions. As noted above, the Board understands that most debit card networks have indicated that they intend to implement two-tier fee structures; however, these are not binding commitments, and the level of interchange fees that will prevail in such systems is currently not known and will depend on market responses. Prior economic research suggests that competition between large and small depository institutions is weaker than competition within either group of institutions, likely because these institutions serve different customer bases.[183] For example, large institutions have

[183] *See, e.g.*, Robert Adams, Kenneth Brevoort, and Elizabeth Kiser, "Who Competes with Whom? The Case of Depository Institutions," *Journal of Industrial Economics*, March 2007, v. 55, iss.1, pp. 141-67; Andrew M. Cohen and Michael J Mazzeo, "Market Structure and Competition among Retail Depository Institutions," *Review of Economics and Statistics*, February 2007, v. 89, iss. 1, pp. 60-74; and Timothy H. Hannan and Robin A. Prager, "The Profitability of Small Single-Market Banks in an Era of Multi-market Banking," *Journal of Banking and Finance,* February 2009, v. 33, iss. 2, pp. 263-71.

tended to attract customers who desire expansive branch and ATM networks and a wide variety of financial instruments; by contrast, smaller institutions often market themselves as offering more individualized, relationship-based service and customer support to consumers and small businesses. This evidence suggests that substitution effects in response to changes in fees or account terms are stronger between depository institutions of similar sizes than across depository institutions of different sizes.

## III. Availability of services to different classes of consumers

"Effects of the rule on various parties" above discussed the comments the Board received regarding the effect the Board's proposed regulation may have on consumers. Furthermore, as discussed in "Effects of the rule on various parties", the ultimate net effect of the final rule on consumers will depend on the behavior of various participants in the debit card networks. Specifically, the effect of the rule on any individual consumer will depend on a variety of factors, including the consumer's current payment behavior (e.g., cash user or debit card user), changes in the consumer's payment behavior, the competitiveness of the merchants from which the consumer makes purchases, changes in merchant payment method acceptance, and changes in the behavior of banks.

For low income consumers, to the extent that fees and other account terms become less attractive as a result of the rule, some low income consumers may be unwilling or unable to obtain debit cards and related deposit accounts. Similarly, less attractive fees and account terms may cause certain low income consumers who previously held debit cards and deposit accounts to substitute away from those products. At the same time, however, low income consumers who currently use cash for purchases may face lower prices at the point of sale if retailers that they frequent set lower prices to reflect lower costs of debit card transactions. Therefore, the net

effect on low income consumers will depend on various factors, including each consumer's payment and purchase behavior, as well as market responses to the rule.

**IV. Conclusion**

EFTA Section 904(a)(3) states that: "to the extent practicable, the Board shall demonstrate that the consumer protections of the proposed regulations outweigh the compliance costs imposed upon consumers and financial institutions." Based on the analysis above and in the **Section-by-Section Analysis**, the Board cannot, at this time, determine whether the benefits to consumers exceed the possible costs to financial institutions. As discussed above and in "Effects of the rule on various parties," the overall effects of the final rule on financial institutions and on consumers are dependent on a variety of factors, and the Board cannot predict the market response to the final rule.

**Final Regulatory Flexibility Analysis**

An initial regulatory flexibility analysis (IRFA) was included in the proposal in accordance with Section 3(a) of the Regulatory Flexibility Act, 5 U.S.C. 601 *et. seq.*(RFA). In the IRFA, the Board requested comments on all aspects of the IRFA, and, in particular, comments on the network exclusivity and routing alternatives (the provisions of the proposal that apply to small issuers). The Board also requested comments on any approaches, other than the proposed alternatives, that would reduce the burden on all entities, including small issuers. Finally, the Board requested comments on any significant alternatives that would minimize the impact of the proposal on small entities.

The RFA requires an agency to prepare a final regulatory flexibility analysis (FRFA) unless the agency certifies that the rule will not, if promulgated, have a significant economic impact on a substantial number of small entities. Although it is difficult to quantify the analysis

at this point, the Board believes that the rule, if promulgated, may have a significant economic impact on a substantial number of small entities and, accordingly, the Board has prepared the following FRFA pursuant to the RFA.

1. *Statement of the need for, and objectives of, the final rule*. As required by EFTA Section 920, the Board is adopting new Regulation II to establish standards for assessing whether an interchange transaction fee received or charged by an issuer is reasonable and proportional to the cost incurred by the issuer with respect to the transaction. Additionally, also as required by EFTA Section 920, new Regulation II prohibits issuers and payment card networks from both restricting the number of payment card networks over which an electronic debit transaction may be processed to less than two unaffiliated networks and inhibiting the ability of a merchant to direct the routing of an electronic debit transaction over a particular payment card network that may process such transactions.

2. *Summary of significant issues raised by public comments in response to the Board's IRFA, the Board's assessment of such issues, and a statement of any changes made as a result of such comments*. The Board received several comments on the IRFA. Some commenters contended that the IRFA should include an analysis of the effect of the proposed rule on small entities, including small merchants and small business debit card holders, as well as a study of the disparate impact of the rule on smaller and larger businesses. One commenter also suggested that the IRFA should consider the effect on small businesses that receive financial services from small banks. Some commenters suggested that the Board's RFA analysis should take into consideration the effect of the rule on consumers, especially consumer debit card holders and lower income individuals. Another commenter argued that the IRFA was not reasonably complete because the cost survey on which the Board based its proposal did not consider small

issuers. As noted above in the sections on "Effects on Various Parties" and the "EFTA 904(a) Economic Analysis," the overall effects of the final rule on exempt issuers, small merchants, consumers, and other parties are dependent on a variety of factors, and the Board cannot predict the market response to the final rule.

In addition, numerous commenters discussed the proposed rule's impact on small entities, particularly small issuers. As discussed in more detail in the **Section-by-Section Analysis**, EFTA Section 920(a)(6)(A) provides an exemption from the interchange fee restrictions under EFTA Section 920(a) for any issuer that, together with its affiliates, has assets of less than $10 billion. Consequently, the provisions related to the interchange fee restrictions in the final rule do not directly impact small issuers. Commenters, however, were concerned that the small issuer exemption would not be effective in practice if payment card networks do not implement two-tier fee structures. As discussed above in this notice, trade associations representing small issuers, including credit unions, and one federal banking agency urged the Board to use its circumvention or evasion authority to ensure that the small issuer exemption in EFTA Section 920(a)(6) from the interchange transaction fee restrictions is given effect by the networks. In particular, these commenters were concerned that absent an express requirement on networks to adopt higher tiers of interchange fees for exempt issuers, such issuers would experience a significant reduction in interchange fee revenue, notwithstanding the exemption.

Although the statute provides an exemption from the interchange transaction fee restrictions for issuers with less than $10 billion in consolidated assets, the statute neither imposes an affirmative duty on networks to implement different interchange transaction fee rates for covered and exempt issuers, nor guarantees a particular level of interchange fee revenue that may be collected by an exempt issuer. As noted above, however, the Board is taking steps to

respond to this issue in two ways. First, the Board plans to survey payment card issuers and networks annually and publish annually a list of the average interchange fees each network provides to its covered issuers and to its exempt issuers. This information will provide for more transparency for issuers, including small issuers, to more readily compare the interchange revenue they would receive from each network. Second, to facilitate a network's implementation of a two-tier fee structure, the Board will also compile annual lists of institutions above and below the small issuer exemption asset threshold. Payment card networks and issuers may then rely on such lists to determine which issuers qualify for the small issuer exemption. Issuers not appearing on the list of issuers that, together with their affiliates, have less than $10 billion in assets may still be required by payment card networks in which they participate to notify the networks that they qualify for the small issuer exemption. The Board believes the publication of the lists will greatly reduce the administrative burden associated with identifying small issuers that qualify for the exemption.

With respect to the network exclusivity and routing provisions, some commenters suggested that the Board exempt small issuers from these requirements. As explained above in the **Section-by-Section Analysis**, the statute does not provide an exemption for small issuers for these provisions. In addition, the exemption authority in EFTA Section 904(c) is transferred to the Consumer Financial Protection Bureau on July 21, 2011.

The Board has discretion, however, in setting the compliance date for these provisions. In designating April 1, 2012, as the date by which most issuers must comply with the network exclusivity provisions and October 1, 2011, as the date by which issuers must comply with the routing provisions, the Board has taken into account the concerns of issuers of all sizes. The technological options available for issuers generally will be the same for all issuers, regardless of

asset size.  Furthermore, as discussed in more detail in the **Section-by-Section Analysis**, certain debit cards have a delayed effective date, and issuers of such cards do not have to comply with the network exclusivity provisions for these cards until April 1, 2013

3. *Description and estimate of small entities affected by the final rule*.  This final rule will apply to small financial institutions that issue debit cards.  A financial institution generally is considered small if it has assets of $175 million or less.[184]  Based on 2010 Call Report data, approximately 11,000 depository institutions had total domestic assets of $175 million or less. The large majority of these institutions issue debit cards.

The sections above on "Effects on Various Parties" and the "EFTA 904(a) Economic Analysis" provide a more detailed discussion of the direct and indirect impact of the rule on various parties.

4. *Projected reporting, recordkeeping, and other compliance requirements.* With respect to the limitations on interchange transaction fees, the Board's final rule does not impose compliance requirements on small issuers.[185]  In accordance with EFTA Section 920 the Board's rule exempts from the limitations on interchange transaction fees all issuers that, together with affiliates, have assets of less than $10 billion.  The Board's final rule does not, however, require payment card networks to distinguish between issuers with assets of $10 billion or more and smaller issuers in setting interchange rates.  If a payment card network decides to distinguish between large and small issuers, small issuers that are not on the Board's list of institutions that, together with their affiliates, have less than $10 billion in assets may need to provide information to the network in order to take advantage of the exempt fee structure.

[184] U.S. Small Business Administration, Table of Small Business Size Standards Matched to North American Industry Classification System Codes, available at http://www.sba.gov/idc/groups/public/documents/sba_homepage/serv_sstd_tablepdf.pdf.

[185] There may be some small financial institutions that have very large affiliates such that the institution does not qualify for the small issuer exemption.

The final rule prohibiting network exclusivity arrangements will affect small financial institutions that issue debit cards if such institutions do not currently comply with the final rule's standards. Under the final rule, a small issuer, like other issuers, would be required to have at least two unaffiliated payment card networks for each debit card it issues. If the issuer does not have at least two unaffiliated payment card networks for each debit card it issues, it would be required to add an additional network. This process may require making a decision as to which additional network to add to the debit card, establishing a connection to the new network, and updating internal processes and procedures.

5. *Steps taken to minimize the economic impact on small entities; significant alternatives*. In its proposed rule, the Board requested comment on the impact of the prohibition on network exclusivity and routing restrictions on small entities and solicited comment on any approaches, other than the proposed alternatives, that would reduce the burden on all entities, including small issuers. The Board received comment suggesting that small issuers should be exempt from the network exclusivity and routing provisions. However, as noted above in the **Section-by-Section Analysis**, EFTA Section 920 does not provide for this exemption, and the Board does not have authority to adopt an exemption for small issuers from these provisions. As noted above, the Board will publish lists of institutions above and below the small issuer exemption asset threshold to facilitate the implementation of two-tier interchange fee structures by payment card networks. In addition, the Board plans to publish annually information regarding the average interchange fees received by exempt issuers and covered issuers in each payment card network; this information may assist exempt issuers in determining the networks in which they wish to participate.

The factual, policy, and legal reasons for selecting the alternatives adopted in the final rule regarding each provision of the rule are discussed above in the **Section-by-Section Analysis** regarding each such provision. In addition, the reasons for rejecting other significant alternatives to the final rule considered by the Board are discussed are those sections as well.

**Paperwork Reduction Act**

In accordance with the Paperwork Reduction Act of 1995 (PRA) (44 U.S.C. 3501 - 3521; 5 CFR 1320 Appendix A.1), the Board reviewed this final rule under the authority delegated to the Board by the Office of Management and Budget. As mentioned in the preamble, the Board is seeking comment, via an interim final rulemaking, on the provisions required under § 235.4 for the fraud–prevention adjustment, published separately in the *Federal Register*. No collections of information pursuant to the PRA are contained in this final rule. Once the Board develops a survey to obtain information under § 235.8, containing recordkeeping and reporting requirements, staff will conduct an analysis under the PRA and seek public comment in the *Federal Register*.

**Use of "Plain Language"**

Section 722 of the Gramm-Leach-Bliley Act of 1999 (12 U.S.C. 4809) requires the Board to use "plain language" in all final rules published after January 1, 2000. The Board has sought to present this final rule in a simple and straight forward manner. The Board received no comments on whether the proposed rule was clearly stated and effectively organized, or on how the Board might make the text of the rule easier to understand.

**Text of Final Rule**

**List of Subjects in 12 CFR Part 235**

Banks, banking, Debit card routing, Electronic debit transactions, and Interchange transaction fees.

**Authority and Issuance**

For the reasons set forth in the preamble, the Board amends Title 12, Chapter II of the Cord of Federal Regulations by adding a new part 235 to read as follows:

**PART 235—DEBIT CARD INTERCHANGE FEES AND ROUTING**

Sec.


235.1 Authority and purpose.

235.2 Definitions.

235.3 Reasonable and proportional interchange fees

235.4 [Reserved]

235.5 Exemptions.

235.6 Prohibition on circumvention, evasion, or net compensation

235.7 Limitation on payment card restrictions

235.8 Reporting and recordkeeping requirements

235.9 Administrative enforcement.

**Appendix A—Official Board Commentary on Regulation II**


**Authority:** 15 U.S.C. 1693o-2.

**§ 235.1 Authority and purpose**

(a) Authority. This part is issued by the Board of Governors of the Federal Reserve System (Board) under section 920 of the Electronic Fund Transfer Act (EFTA) (15 U.S.C. § 1693o-2, as added by section 1075 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010)).

(b) Purpose. This part implements the provisions of section 920 of the EFTA, including standards for reasonable and proportional interchange transaction fees for electronic debit transactions, standards for receiving a fraud-prevention adjustment to interchange transaction fees, exemptions from the interchange transaction fee limitations, prohibitions on evasion and circumvention, prohibitions on payment card network exclusivity arrangements and routing restrictions for debit card transactions, and reporting requirements for debit card issuers and payment card networks.

**§ 235.2 Definitions**

(a) Account (1) Means a transaction, savings, or other asset account (other than an occasional or incidental credit balance in a credit plan) established for any purpose and that is located in the United States; and

(2) Does not include an account held under a bona fide trust agreement that is excluded by section 903(2) of the Electronic Fund Transfer Act and rules prescribed thereunder.

(b) Acquirer means a person that contracts directly or indirectly with a merchant to provide settlement for the merchant's electronic debit transactions over a payment card network. An acquirer does not include a person that acts only as a processor for the services it provides to the merchant.

(c) Affiliate means any company that controls, is controlled by, or is under common control with another company.

(d) Cardholder means the person to whom a debit card is issued.

(e) Control of a company means—

(1) Ownership, control, or power to vote 25 percent or more of the outstanding shares of any class of voting security of the company, directly or indirectly, or acting through one or more other persons;

(2) Control in any manner over the election of a majority of the directors, trustees, or general partners (or individuals exercising similar functions) of the company; or

(3) The power to exercise, directly or indirectly, a controlling influence over the management or policies of the company, as the Board determines.

(f) Debit card (1) Means any card, or other payment code or device, issued or approved for use through a payment card network to debit an account, regardless of whether authorization is based on signature, personal identification number (PIN), or other means, and regardless of whether the issuer holds the account, and

(2) Includes any general-use prepaid card; and

(3) Does not include—

(i) Any card, or other payment code or device, that is redeemable upon presentation at only a single merchant or an affiliated group of merchants for goods or services; or

(ii) A check, draft, or similar paper instrument, or an electronic representation thereof.

(g) Designated automated teller machine (ATM) network means either—

(1) All ATMs identified in the name of the issuer; or

(2) Any network of ATMs identified by the issuer that provides reasonable and convenient access to the issuer's customers.

(h) Electronic debit transaction (1) Means the use of a debit card by a person as a form of payment in the United States to initiate a debit to an account, and

(2) Does not include transactions initiated at an ATM, including cash withdrawals and balance transfers initiated at an ATM.

(i) General-use prepaid card means a card, or other payment code or device, that is—

(1) Issued on a prepaid basis in a specified amount, whether or not that amount may be increased or reloaded, in exchange for payment; and

(2) Redeemable upon presentation at multiple, unaffiliated merchants for goods or services.

(j) Interchange transaction fee means any fee established, charged, or received by a payment card network and paid by a merchant or an acquirer for the purpose of compensating an issuer for its involvement in an electronic debit transaction.

(k) Issuer means any person that authorizes the use of a debit card to perform an electronic debit transaction.

(l) Merchant means any person that accepts debit cards as payment.

(m) Payment card network means an entity that—

(1) Directly or indirectly provides the proprietary services, infrastructure, and software that route information and data to an issuer from an acquirer to conduct the authorization, clearance, and settlement of electronic debit transactions; and

(2) A merchant uses in order to accept as a form of payment a brand of debit card or other device that may be used to carry out electronic debit transactions.

(n) Person means a natural person or an organization, including a corporation, government agency, estate, trust, partnership, proprietorship, cooperative, or association.

(o) Processor means a person that processes or routes electronic debit transactions for issuers, acquirers, or merchants.

(p) Route means to direct and send information and data to an unaffiliated entity or to an affiliated entity acting on behalf of an unaffiliated entity.

(q) United States means the States, territories, and possessions of the United States, the District of Columbia, the Commonwealth of Puerto Rico, or any political subdivision of any of the foregoing.

**§ 235.3 Reasonable and proportional interchange transaction fees**

(a) In general. The amount of any interchange transaction fee that an issuer may receive or charge with respect to an electronic debit transaction shall be reasonable and proportional to the cost incurred by the issuer with respect to the electronic debit transaction.

(b) Determination of reasonable and proportional fees. An issuer complies with the requirements of paragraph (a) of this section only if each interchange transaction fee received or charged by the issuer for an electronic debit transaction is no more than the sum of—

(1) 21 cents and;

(2) 5 basis points multiplied by the value of the transaction.

**§ 235.4 [Reserved]**

**§ 235.5 Exemptions**

(a) Exemption for small issuers. (1) In general. Except as provided in paragraph (a)(3) of this section, §§ 235.3, 235.4, and 235.6 do not apply to an interchange transaction fee received or charged by an issuer with respect to an electronic debit transaction if—

(i) The issuer holds the account that is debited; and

(ii) The issuer, together with its affiliates, has assets of less than $10 billion as of the end of the calendar year preceding the date of the electronic debit transaction.

(2) Determination of issuer asset size. A person may rely on lists published by the Board to determine whether an issuer, together with its affiliates, has assets of less than $10 billion as of the end of the calendar year preceding the date of the electronic debit transaction.

(3) Change in status. If an issuer qualifies for the exemption in paragraph (a)(1) in a particular calendar year, but, as of the end of that calendar year no longer qualifies for the exemption because at that time it, together with its affiliates, has assets of $10 billion or more, the issuer must begin complying with §§ 235.3, 235.4, and 235.6 no later than July 1 of the succeeding calendar year.

(b) Exemption for government-administered programs. Except as provided in paragraph (d) of this section, §§ 235.3, 235.4, and 235.6 do not apply to an interchange transaction fee received or charged by an issuer with respect to an electronic debit transaction if—

(1) The electronic debit transaction is made using a debit card that has been provided to a person pursuant to a Federal, State, or local government-administered payment program; and

(2) The cardholder may use the debit card only to transfer or debit funds, monetary value, or other assets that have been provided pursuant to such program.

(c) Exemption for certain reloadable prepaid cards. (1) In general. Except as provided in paragraph (d) of this section, §§ 235.3, 235.4, and 235.6 do not apply to an interchange transaction fee received or charged by an issuer with respect to an electronic debit transaction using a general-use prepaid card that is—

(i) Not issued or approved for use to access or debit any account held by or for the benefit of the cardholder (other than a subaccount or other method of recording or tracking funds purchased or loaded on the card on a prepaid basis);

(ii) Reloadable and not marketed or labeled as a gift card or gift certificate; and

(iii) The only means of access to the underlying funds, except when all remaining funds are provided to the cardholder in a single transaction.

(2) Temporary cards. For purposes of this paragraph (c), the term “reloadable” includes a temporary non-reloadable card issued solely in connection with a reloadable general-use prepaid card.

(d) Exception. The exemptions in paragraphs (b) and (c) of this section do not apply to any interchange transaction fee received or charged by an issuer on or after July 21, 2012, with respect to an electronic debit transaction if any of the following fees may be charged to a cardholder with respect to the card:

(1) A fee or charge for an overdraft, including a shortage of funds or a transaction processed for an amount exceeding the account balance, unless the fee or charge is imposed for transferring funds from another asset account to cover a shortfall in the account accessed by the card; or

(2) A fee imposed by the issuer for the first withdrawal per calendar month from an ATM that is part of the issuer’s designated ATM network.

### § 235.6 Prohibition on circumvention, evasion, and net compensation

(a) Prohibition of circumvention or evasion. No person shall circumvent or evade the interchange transaction fee restrictions in §§ 235.3 and 235.4.

(b) Prohibition of net compensation. An issuer may not receive net compensation from a payment card network with respect to electronic debit transactions or debit card-related activities within a calendar year. Net compensation occurs when the total amount of payments or incentives received by an issuer from a payment card network with respect to electronic debit transactions or debit card-related activities, other than interchange transaction fees passed through to the issuer by the network, during a calendar year exceeds the total amount of all fees paid by the issuer to the network with respect to electronic debit transactions or debit card-related activities during that calendar year. Payments and incentives paid by a network to an issuer, and fees paid by an issuer to a network, with respect to electronic debit transactions or debit card related activities are not limited to volume-based or transaction-specific payments, incentives, or fees, but also include other payments, incentives or fees related to an issuer's provision of debit card services.

**§ 235.7 Limitations on payment card restrictions**

(a) Prohibition on network exclusivity. (1) In general. An issuer or payment card network shall not directly or through any agent, processor, or licensed member of a payment card network, by contract, requirement, condition, penalty, or otherwise, restrict the number of payment card networks on which an electronic debit transaction may be processed to less than two unaffiliated networks.

(2) Permitted arrangements. An issuer satisfies the requirements of paragraph (a)(1) of this section only if the issuer allows an electronic debit transaction to be processed on at least two unaffiliated payment card networks, each of which does not, by rule or policy, restrict the operation of the network to a limited geographic area, specific merchant, or particular type of merchant or transaction, and each of which has taken steps reasonably designed to enable the

network to process the electronic debit transactions that the network would reasonably expect will be routed to it, based on expected transaction volume.

(3) Prohibited exclusivity arrangements by networks. For purposes of paragraph (a)(1) of this section, a payment card network may not restrict or otherwise limit an issuer's ability to contract with any other payment card network that may process an electronic debit transaction involving the issuer's debit cards.

(4) Subsequent affiliation. If unaffiliated payment card networks become affiliated as a result of a merger or acquisition such that an issuer is no longer in compliance with paragraph (a) of this section, the issuer must add an unaffiliated payment card network through which electronic debit transactions on the relevant debit card may be processed no later than six months after the date on which the previously unaffiliated payment card networks consummate the affiliation.

(b) Prohibition on routing restrictions. An issuer or payment card network shall not, directly or through any agent, processor, or licensed member of the network, by contract, requirement, condition, penalty, or otherwise, inhibit the ability of any person that accepts or honors debit cards for payments to direct the routing of electronic debit transactions for processing over any payment card network that may process such transactions.

(c) Effective dates. (1) General. Except as otherwise provided in paragraphs (c)(2), (c)(3), and (c)(4) of this section, paragraph (a) of this section becomes effective on April 1, 2012. Paragraph (b) of this section becomes effective on October 1, 2011.

(2) Restrictions by payment card networks. Paragraphs (a)(1) and (a)(3) of this section become effective for payment card networks on October 1, 2011.

(3) Debit cards that use transaction qualification or substantiation systems. Issuers shall comply with the requirements of paragraph (a) of this section by April 1, 2013, for electronic debit transactions using debit cards that use point-of-sale transaction qualification or substantiation systems for verifying the eligibility of purchased goods or services.

(4) General-use prepaid cards. Issuers shall comply with the requirements of paragraph (a) of this section with respect to general-use prepaid cards as set out below.

(i) With respect to non-reloadable general-use prepaid cards, the effective date is April 1, 2013. Non-reloadable general-use prepaid cards sold prior to April 1, 2013 are not subject to paragraph (a) of this section.

(ii) With respect to reloadable general-use prepaid cards, the effective date is April 1, 2013. Reloadable general-use prepaid cards sold prior to April 1, 2013 are not subject to paragraph (a) of this section unless and until they are reloaded, in which case the following effective dates apply:

(A) With respect to reloadable general-use prepaid cards sold and reloaded prior to April 1, 2013, the effective date is May 1, 2013.

(B) With respect to reloadable general-use prepaid cards sold prior to April 1, 2013, and reloaded on or after April 1, 2013, the effective date is 30 days after the date of reloading.

**§ 235.8 Reporting Requirements and Record Retention**

(a) Entities required to report. Each issuer that is not otherwise exempt from the requirements of this part under § 235.5(a) and each payment card network shall file a report with the Board in accordance with this section.

(b) Report. Each entity required to file a report with the Board shall submit data in a form prescribed by the Board for that entity. Data required to be reported may include, but may not be limited to, data regarding costs incurred with respect to an electronic debit transaction, interchange transaction fees, network fees, fraud-prevention costs, fraud losses, and transaction value, volume, and type.

(c) Record retention. (1) An issuer subject to this part shall retain evidence of compliance with the requirements imposed by this part for a period of not less than five years after the end of the calendar year in which the electronic debit transaction occurred.

(2) Any person subject to this part having actual notice that it is the subject of an investigation or an enforcement proceeding by its enforcement agency shall retain the records that pertain to the investigation, action, or proceeding until final disposition of the matter unless an earlier time is allowed by court or agency order.

**§ 235.9 Administrative Enforcement**

(a) (1) Compliance with the requirements of this part shall be enforced under—

(i) Section 8 of the Federal Deposit Insurance Act, by the appropriate Federal banking agency, as defined in section 3(q) of the Federal Deposit Insurance Act (12 USC 1813(q)), with respect to—

(A) national banks, federal savings associations, and federal branches and federal agencies of foreign banks;

(B) member banks of the Federal Reserve System (other than national banks), branches and agencies of foreign banks (other than federal branches, federal Agencies, and insured state branches of foreign banks), commercial lending companies owned or controlled by foreign banks, and organizations operating under section 25 or 25A of the Federal Reserve Act;

(C) banks and state savings associations insured by the Federal Deposit Insurance Corporation (other than members of the Federal Reserve System), and insured state branches of foreign banks;

(ii) the Federal Credit Union Act (12 USC 1751 et seq.), by the Administrator of the National Credit Union Administration (National Credit Union Administration Board) with respect to any federal credit union;

(iii) the Federal Aviation Act of 1958 (49 USC 40101 et seq.), by the Secretary of Transportation, with respect to any air carrier or foreign air carrier subject to that Act; and

(iv) the Securities Exchange Act of 1934 (15 USC 78a et seq.), by the Securities and Exchange Commission, with respect to any broker or dealer subject to that Act.

(2) The terms used in paragraph (a)(1) of this section that are not defined in this part or otherwise defined in section 3(s) of the Federal Deposit Insurance Act (12 USC 1813(s)) shall have the meaning given to them in section 1(b) of the International Banking Act of 1978 (12 USC 3101).

(b) Additional powers. (1) For the purpose of the exercise by any agency referred to in paragraphs (a)(1)(i) through (a)(1)(iv) of this section of its power under any statute referred to in those paragraphs, a violation of this part is deemed to be a violation of a requirement imposed under that statute.

(2) In addition to its powers under any provision of law specifically referred to in paragraphs (a)(1)(i) through (a)(1)(iv) of this section, each of the agencies referred to in those paragraphs may exercise, for the purpose of enforcing compliance under this part, any other authority conferred on it by law.

(c) Enforcement authority of Federal Trade Commission. Except to the extent that enforcement of the requirements imposed under this title is specifically granted to another government agency under paragraphs (a)(1)(i) through (a)(1)(iv) of this section, and subject to subtitle B of the Consumer Financial Protection Act of 2010, the Federal Trade Commission has the authority to enforce such requirements. For the purpose of the exercise by the Federal Trade Commission of its functions and powers under the Federal Trade Commission Act, a violation of this part shall be deemed a violation of a requirement imposed under the Federal Trade Commission Act. All of the functions and powers of the Federal Trade Commission under the Federal Trade Commission Act are available to the Federal Trade Commission to enforce compliance by any person subject to the jurisdiction of the Federal Trade Commission with the requirements of this part, regardless of whether that person is engaged in commerce or meets any other jurisdictional tests under the Federal Trade Commission Act.

**§ 235.10 Effective Date**

Except as provided in § 235.7, this part becomes effective and compliance is mandatory on October 1, 2011.

**Appendix A – Official Board Commentary on Regulation II**

**Introduction**

The following commentary to Regulation II (12 CFR part 235) provides background material to explain the Board's intent in adopting a particular part of the regulation. The commentary also provides examples to aid in understanding how a particular requirement is to work.

**§ 235.2 Definitions**

2(a) Account

1. Types of accounts. The term "account" includes accounts held by any person, including consumer accounts (i.e., those established primarily for personal, family or household purposes) and business accounts. Therefore, the limitations on interchange transaction fees and the prohibitions on network exclusivity arrangements and routing restrictions apply to all electronic debit transactions, regardless of whether the transaction involves a debit card issued primarily for personal, family, or household purposes or for business purposes. For example, an issuer of a business-purpose debit card is subject to the restrictions on interchange transaction fees and is also prohibited from restricting the number of payment card networks on which an electronic debit transaction may be processed under § 235.7.

2. Bona fide trusts. This part does not define the term bona fide trust agreement; therefore, institutions must look to state or other applicable law for interpretation. An account held under a custodial agreement that qualifies as a trust under the Internal Revenue Code, such as an individual retirement account, is considered to be held under a trust agreement for purposes of this part.

3. Account located in the United States. This part applies only to electronic debit transactions that are initiated to debit (or credit, for example, in the case of returned goods or cancelled services) an account located in the United States. If a cardholder uses a debit card to debit an account held outside the United States, then the electronic debit transaction is not subject to this part.

2(b) Acquirer

1. In general. The term "acquirer" includes only the institution that contracts, directly or indirectly, with a merchant to provide settlement for the merchant's electronic debit transactions over a payment card network (referred to as acquiring the merchant's electronic debit transactions). In some acquiring relationships, an institution provides processing services to the merchant and is a licensed member of the payment card network, but does not settle the transactions with the merchant (by crediting the merchant's account) or with the issuer. These institutions are not "acquirers" because they do not provide credit to the merchant for the transactions or settle the merchant's transactions with the issuer. These institutions are considered processors and in some circumstances may be considered payment card networks for purposes of this part (See §§ 235.2(m), 235.2(o), and commentary thereto).

2(c) Affiliate

1. Types of entities. The term "affiliate" includes any bank and nonbank affiliates located in the United States or a foreign country.

2. Other affiliates. For commentary on whether merchants are affiliated, see comment 2(f)-7.

2(d) Cardholder

1. Scope. In the case of debit cards that access funds in transaction, savings, or other similar asset accounts, "the person to whom a card is issued" generally will be the named person or persons holding the account. If the account is a business account, multiple employees (or other persons associated with the business) may have debit cards that can access the account. Each employee that has a debit card that can access the account is a cardholder. In the case of a

prepaid card, the cardholder generally is either the purchaser of the card or a person to whom the purchaser gave the card, such as a gift recipient.

2(e) Control [Reserved]

2(f) Debit card

1. Card, or other payment code or device. The term "debit card" as defined in § 235.2(f) applies to any card, or other payment code or device, even if it is not issued in a physical form. Debit cards include, for example, an account number or code that can be used to access funds in an account to make Internet purchases. Similarly, the term "debit card" includes a device with a chip or other embedded mechanism, such as a mobile phone or sticker containing a contactless chip that links the device to funds stored in an account, and enables an account to be debited. The term "debit card," however, does not include a one-time password or other code if such password or code is used for the purposes of authenticating the cardholder and is used in addition to another card, or other payment code or device, rather than as the payment code or device.

2. Deferred debit cards. The term "debit card" includes a card, or other payment code or device, that is used in connection with deferred debit card arrangements in which transactions are not immediately posted to and funds are not debited from the underlying transaction, savings, or other asset account upon settlement of the transaction. Instead, the funds in the account typically are held and made unavailable for other transactions for a period of time specified in the issuer-cardholder agreement. After the expiration of the time period, the cardholder's account is debited for the value of all transactions made using the card that have been submitted to the issuer for settlement during that time period. For example, under some deferred debit card arrangements, the issuer may debit the consumer's account for all debit card transactions that

occurred during a particular month at the end of the month. Regardless of the time period between the transaction and account posting, a card, or other payment code or device, that is used in connection with a deferred debit arrangement is considered a debit card for purposes of the requirements of this part.

3. Decoupled debit cards. Decoupled debit cards are issued by an entity other than the financial institution holding the cardholder's account. In a decoupled debit arrangement, transactions that are authorized by the card issuer settle against the cardholder's account held by an entity other than the issuer, generally via a subsequent ACH debit to that account. The term "debit card" includes any card, or other payment code or device, issued or approved for use through a payment card network to debit an account, regardless of whether the issuer holds the account. Therefore, decoupled debit cards are debit cards for purposes of this part.

4. Hybrid cards.

i. Some cards, or other payment codes or devices, may have both credit- and debit-like features ("hybrid cards"). For example, these cards may enable a cardholder to access a line of credit, but select certain transactions for immediate repayment (i.e., prior to the end of a billing cycle) via a debit to the cardholder's account, as the term is defined in § 235.2(a), held either with the issuer or at another institution. If a card permits a cardholder to initiate transactions that debit an account or funds underlying a prepaid card, the card is considered a debit card for purposes of this part. Not all transactions initiated by such a hybrid card, however, are electronic debit transactions. Rather, only those transactions that debit an account as defined in this part or funds underlying a prepaid card are electronic debit transactions. If the transaction posts to a line of credit, then the transaction is a credit transaction.

ii. If an issuer conditions the availability of a credit or charge card that permits pre-authorized repayment of some or all transactions on the cardholder maintaining an account at the issuer, such a card is considered a debit card for purposes of this part.

5. Virtual wallets. A virtual wallet is a device (e.g., a mobile phone) that stores several different payment codes or devices ("virtual cards") that access different accounts, funds underlying the card, or lines of credit. At the point of sale, the cardholder may select from the virtual wallet the virtual card he or she wishes to use for payment. The virtual card that the cardholder uses for payment is considered a debit card under this part if the virtual card that initiates a transaction meets the definition of debit card, notwithstanding the fact that other cards in the wallet may not be debit cards.

6. General-use prepaid card. The term "debit card" includes general-use prepaid cards. See § 235.2(i) and related commentary for information on general-use prepaid cards.

**7**. Store cards. The term "debit card" does not include prepaid cards that may be used at a single merchant or affiliated merchants. Two or more merchants are affiliated if they are related by either common ownership or by common corporate control. For purposes of the "debit card" definition, franchisees are considered to be under common corporate control if they are subject to a common set of corporate policies or practices under the terms of their franchise licenses.

8. Checks, drafts, and similar instruments. The term "debit card" does not include a check, draft, or similar paper instrument or a transaction in which the check is used as a source of information to initiate an electronic payment. For example, if an account holder provides a check to buy goods or services and the merchant takes the account number and routing number

information from the MICR line at the bottom of a check to initiate an ACH debit transfer from the cardholder's account, the check is not a debit card, and such a transaction is not considered an electronic debit transaction. Likewise, the term "debit card" does not include an electronic representation of a check, draft, or similar paper instrument.

9. ACH transactions. The term "debit card" does not include an account number when it is used by a person to initiate an ACH transaction that debits that person's account. For example, if an account holder buys goods or services over the Internet using an account number and routing number to initiate an ACH debit, the account number is not a debit card, and such a transaction is not considered an electronic debit transaction. However, the use of a card to purchase goods or services that debits the cardholder's account that is settled by means of a subsequent ACH debit initiated by the card issuer to the cardholder's account, as in the case of a decoupled debit card arrangement, involves the use of a debit card for purposes of this part.

2(g) Designated automated teller machine (ATM) network

1. Reasonable and convenient access clarified. Under § 235.2(g)(2), a designated ATM network includes any network of ATMs identified by the issuer that provides reasonable and convenient access to the issuer's cardholders. Whether a network provides reasonable and convenient access depends on the facts and circumstances, including the distance between ATMs in the designated network and each cardholder's last known home or work address, or if a home or work address is not known, where the card was first issued.

2(h) Electronic debit transaction

1. Debit an account. The term "electronic debit transaction" includes the use of a card to debit an account. The account debited could be, for example, the cardholder's asset account or the account that holds the funds used to settle prepaid card transactions.

2. Form of payment. The term "electronic debit transaction" includes the use of a card as a form of payment that may be made in exchange for goods or services, as a charitable contribution, to satisfy an obligation (e.g., tax liability), or for other purposes.

3. Subsequent transactions. The term "electronic debit transaction" includes both the cardholder's use of a debit card for the initial payment and any subsequent use by the cardholder of the debit card in connection with the initial payment. For example, the term "electronic debit transaction" includes using the debit card to return merchandise or cancel a service that then results in a debit to the merchant's account and a credit to the cardholder's account.

4. Cash withdrawal at the point of sale. The term "electronic debit transaction" includes a transaction in which a cardholder uses the debit card both to make a purchase and to withdraw cash (known as a "cash-back transaction").

5. Geographic limitation. This regulation applies only to electronic debit transactions that are initiated at a merchant located in the United States. If a cardholder uses a debit card at a merchant located outside the United States to debit an account held in the United States, the electronic debit transaction is not subject to this part.

2(i) General-use prepaid card

1. Redeemable upon presentation at multiple, unaffiliated merchants. A prepaid card is redeemable upon presentation at multiple, unaffiliated merchants if such merchants agree to honor the card.

2. Selective authorization cards. Selective authorization cards, (e.g., mall cards) are generally intended to be used or redeemed for goods or services at participating retailers within a shopping mall or other limited geographic area. Selective authorization cards are considered general-use prepaid cards, regardless of whether they carry the mark, logo, or brand of a payment card network, if they are redeemable at multiple, unaffiliated merchants.

2(j) Interchange transaction fee

1. In general. Generally, the payment card network is the entity that establishes and charges the interchange transaction fee to the acquirers or merchants. The acquirers then pay to the issuers any interchange transaction fee established and charged by the network. Acquirers typically pass the interchange transaction fee through to merchant-customers.

2. Compensating an issuer. The term "interchange transaction fee" is limited to those fees that a payment card network establishes, charges, or receives to compensate the issuer for its role in the electronic debit transaction. By contrast, payment card networks generally charge issuers and acquirers fees for services the network performs. Such fees are not interchange transaction fees because the payment card network is charging and receiving the fee as compensation for services it provides.

3. Established, charged, or received. Interchange transaction fees are not limited to those fees for which a payment card network sets the value. A fee that compensates an issuer is an

interchange transaction fee if the fee is set by the issuer but charged to acquirers by virtue of the network determining each participant's net settlement position.

2(k) Issuer

1. In general. A person issues a debit card by authorizing the use of debit card by a cardholder to perform electronic debit transactions. That person may provide the card directly to the cardholder or indirectly by using a third party (such as a processor, or a telephone network or manufacturer) to provide the card, or other payment code or device, to the cardholder. The following examples illustrate the entity that is the issuer under various card program arrangements. For purposes of determining whether an issuer is exempted under § 235.5(a), however, the term issuer is limited to the entity that holds the account being debited.

2. Traditional debit card arrangements. In a traditional debit card arrangement, the bank or other entity holds the cardholder's funds and authorizes the cardholder to use the debit card to access those funds through electronic debit transactions, and the cardholder receives the card directly or indirectly (e.g., through an agent) from the bank or other entity that holds the funds (except for decoupled debit cards, discussed below). In this system, the bank or entity holding the cardholder's funds is the issuer.

3. BIN-sponsor arrangements. Payment card networks assign Bank Identification Numbers (BINs) to member-institutions for purposes of issuing cards, authorizing, clearing, settling, and other processes. In exchange for a fee or other financial considerations, some members of payment card networks permit other entities to issue debit cards using the member's BIN. The entity permitting the use of its BIN is referred to as the "BIN sponsor" and the entity

that uses the BIN to issue cards is often referred to as the "affiliate member." BIN sponsor arrangements can follow at least two different models:

i. Sponsored debit card model. In some cases, a community bank or credit union may provide debit cards to its account holders through a BIN sponsor arrangement with a member institution. In general, the bank or credit union will authorize its account holders to use debit cards to perform electronic debit transactions that access funds in accounts at the bank or credit union. The bank or credit union's name typically will appear on the debit card. The bank or credit union may directly or indirectly provide the cards to cardholders. Under these circumstances, the bank or credit union is the issuer for purposes of this part. If that bank or credit union, together with its affiliates, has assets of less than $10 billion, then that bank or credit union is exempt from the interchange transaction fee restrictions. Although the bank or credit union may distribute cards through the BIN sponsors, the BIN sponsor does not enter into the agreement with the cardholder that authorizes the cardholder to use the card to perform electronic debit transactions that access funds in the account at the bank or credit union, and therefore the BIN sponsor is not the issuer.

ii. Prepaid card model. A member institution may also serve as the BIN sponsor for a prepaid card program. Under these arrangements, a program manager distributes prepaid cards to the cardholders and the BIN-sponsoring institution generally holds the funds for the prepaid card program in an omnibus or pooled account. Either the BIN sponsor or the prepaid card program manager may keep track of the underlying funds for each individual prepaid card through subaccounts. While the cardholder may receive the card directly from the program manager or at a retailer, the BIN sponsor authorizes the cardholder to use the card to perform electronic debit transactions that access the funds in the pooled account and the cardholder's

relationship generally is with the BIN sponsor. Accordingly, under these circumstances, the BIN sponsor, or the bank holding the pooled account, is the issuer.

4. Decoupled debit cards. In the case of decoupled debit cards, an entity other than the bank holding the cardholder's account enters into a relationship with the cardholder authorizing the use of the card to perform electronic debit transactions. The entity authorizing the use of the card to perform electronic debit transaction typically arranges for the card to be provided directly or indirectly to the cardholder and has a direct relationship with the cardholder with respect to the card. The bank holding the cardholder's account has agreed generally to permit ACH debits to the account, but has not authorized the use of the debit card to access the funds through electronic debit transactions. Under these circumstances, the entity authorizing the use of the debit card, and not the account-holding institution, is considered the issuer. An issuer of a decoupled debit card is not exempt under § 235.5(a), even if, together with its affiliates, it has assets of less than $10 billion, because it is not the entity holding the account to be debited.

2(l) Merchant [Reserved]

2(m) Payment card network

1. In general. An entity is a considered a payment card network with respect to an electronic debit transaction for purposes of this rule if it routes information and data to the issuer from the acquirer to conduct authorization, clearance, and settlement of the electronic debit transaction. By contrast, if an entity receives transaction information and data from a merchant and authorizes and settles the transaction without routing the information and data to another entity (i.e., the issuer or the issuer's processor) for authorization, clearance, or settlement, that entity is not considered a payment card network with respect to the electronic debit transaction.

2. Three-party systems. In the case of a three-party system, electronic debit transactions are processed by an entity that acts as system operator and issuer, and may also act as the acquirer. The entity acting as system operator and issuer that receives the transaction information from the merchant or acquirer also holds the cardholder's funds. Therefore, rather than directing the transaction information to a separate issuer, the entity authorizes and settles the transaction based on the information received from the merchant. As these entities do not connect (or "network") multiple issuers and do not route information to conduct the transaction, they are not "payment card networks" with respect to these transactions.

3. Processors as payment card networks. A processor is considered a payment card network if, in addition to acting as processor for an acquirer and issuer, the processor routes transaction information and data received from a merchant or the merchant's acquirer to an issuer. For example, if a merchant uses a processor in order to accept any, some, or all brands of debit cards and the processor routes transaction information and data to the issuer or issuer's processor, the merchant's processor is considered a payment card network with respect to the electronic debit transaction. If the processor establishes, charges, or receives a fee for the purpose of compensating an issuer, that fee is considered an interchange transaction fee for purposes of this part.

4. Automated clearing house (ACH) operators. An ACH operator is not considered a payment card network for purposes of this part. While an ACH operator processes transactions that debit an account and provides for interbank clearing and settlement of such transactions, a person does not use the ACH system to accept as a form of payment a brand of debit card.

5. ATM networks. An ATM network is not considered a payment card network for purposes of this part. While ATM networks process transactions that debit an account and provide for interbank clearing and settlement of such transactions, a cash withdrawal from an ATM is not a payment because there is no exchange of money for goods or services, or payment made as a charitable contribution, to satisfy an obligation (e.g., tax liability), or for other purposes.

2(n) Person [Reserved]

2(o) Processor

1. Distinction from acquirers. A processor may perform all transaction-processing functions for a merchant or acquirer, but if it does not acquire (that is, settle with the merchant for the transactions), it is not an acquirer. The entity that acquirers electronic debit transactions is the entity that is responsible to other parties to the electronic debit transaction for the amount of the transaction.

2. Issuers. A processor may perform services related to authorization, clearance, and settlement of transactions for an issuer without being considered to be an issuer for purposes of this part.

2(p) Route

1. An entity routes information if it both directs and sends the information to an unaffiliated entity (or affiliated entity acting on behalf of the unaffiliated entity). This other entity may be a payment card network or processor (if the entity directing and sending the

information is a merchant or an acquirer) or an issuer or processor (if the entity directing and sending the information is a payment card network).

2(q) United States [Reserved]

### § 235.3 Reasonable and proportional interchange transaction fees

3(a) [Reserved]

3(b) Determining reasonable and proportional fees

1. Two components. The standard for the maximum permissible interchange transaction fee that an issuer may receive consists of two components: a base component that does not vary with a transaction's value and an *ad valorem* component. The amount of any interchange transaction fee received or charged by an issuer may not exceed the sum of the maximum permissible amounts of each component and any fraud-prevention adjustment the issuer is permitted to receive under § 235.4 of this part.

2. Variation in interchange fees. An issuer is permitted to charge or receive, and a network is permitted to establish, interchange transaction fees that vary in their base component and ad valorem component based on, for example, the type of transaction or merchant, provided the amount of any interchange transaction fee for any transaction does not exceed the sum of the maximum permissible base component of 21 cents and 5 basis points of the value of the transaction.

3. Example. For a $39 transaction, the maximum permissible interchange transaction fee is 22.95 cents (21 cents plus 5 basis points of $39). A payment card network may, for example, establish an interchange transaction fee of 22 cents without any *ad valorem* component.

**§ 235.4 [Reserved]**

**§235.5 Exemptions for certain electronic debit transactions**

§235.5 In general

1. Eligibility for multiple exemptions. An electronic debit transaction may qualify for one or more exemptions. For example, a debit card that has been provided to a person pursuant to a Federal, State, or local government-administered payment program may be issued by an entity that, together with its affiliates, has assets of less than $10 billion as of the end of the preceding calendar year. In this case, an electronic debit transaction made using that card may qualify for the exemption under § 235.5(a) for small issuers or for the exemption under § 235.5(b) for government-administered payment programs. A payment card network establishing interchange fees for transactions that qualify for more than one exemption need only satisfy itself that the issuer's transactions qualify for at least one of the exemptions in order to exempt the electronic debit transaction from the interchange fee restrictions.

2. Certification process. Payment card networks that plan to allow issuers to receive higher interchange fees than permitted under §§ 235.3 and 235.4 pursuant to one of the exemptions in § 235.5 could develop their own processes for identifying issuers and products eligible for such exemptions. Section 235.5(a)(2) permits payment card networks to rely on lists published by the Board to help determine eligibility for the small issuer exemption set forth in § 235.5(a)(1).

5(a) Exemption for small issuers

1. Asset size determination. An issuer would qualify for the small-issuer exemption if its total worldwide banking and nonbanking assets, including assets of affiliates, other than trust assets under management, are less than $10 billion, as of December 31 of the preceding calendar year.

2. Change in status. If an exempt issuer becomes covered based on its and its affiliates assets at the end of a calendar year, that issuer must begin complying with the interchange fee standards (§ 235.3), the fraud-prevention adjustment standards (to the extent the issuer wishes to receive a fraud-prevention adjustment) (§ 235.4), and the provisions prohibiting circumvention, evasion, and net compensation (§ 235.6) no later than July 1.

5(b) Exemption for government-administered payment programs

1. Government-administered payment program. A program is considered government-administered regardless of whether a Federal, State, or local government agency operates the program or outsources some or all functions to third parties so long as the program is operated on behalf of the government agency. In addition, a program may be government-administered even if a Federal, State, or local government agency is not the source of funds for the program it administers. For example, child support programs are government-administered programs even though a Federal, State, or local government agency is not the source of funds. A tribal government is considered a local government for purposes of this exemption.

5(c) Exemption for certain reloadable prepaid cards

1. Subaccount clarified. A subaccount is an account within an account, opened in the name of an agent, nominee, or custodian for the benefit of two or more cardholders, where the transactions and balances of individual cardholders are tracked in such subaccounts. An account that is opened solely in the name of a single cardholder is not a subaccount.

2. Reloadable. A general-use prepaid card is "reloadable" if the terms and conditions of the agreement permit funds to be added to the general-use prepaid card at any time after the initial purchase or issuance. A general-use prepaid card is not "reloadable" merely because the issuer or processor is technically able to add functionality that would otherwise enable the general-use prepaid card to be reloaded.

3. Marketed or labeled as a gift card or gift certificate. Electronic debit transactions made using a reloadable general-use prepaid card are not exempt from the interchange fee restrictions if the card is marketed or labeled as a gift card or gift certificate. The term "marketed or labeled as a gift card or gift certificate" means directly or indirectly offering, advertising or otherwise suggesting the potential use of a general-use prepaid card as a gift for another person. Whether the exclusion applies generally does not depend on the type of entity that makes the promotional message. For example, a card may be marketed or labeled as a gift card or gift certificate if anyone (other than the purchaser of the card), including the issuer, the retailer, the program manager that may distribute the card, or the payment network on which a card is used, promotes the use of the card as a gift card or gift certificate. A general-use prepaid card is marketed or labeled as a gift card or gift certificate even if it is only occasionally marketed as a gift card or gift certificate. For example, a network-branded general purpose reloadable card would be marketed or labeled as a gift card or gift certificate if the issuer principally advertises the card as a less costly alternative to a bank account but promotes the card

in a television, radio, newspaper, or Internet advertisement, or on signage as “the perfect gift” during the holiday season.

The mere mention of the availability of gift cards or gift certificates in an advertisement or on a sign that also indicates the availability of exempted general-use prepaid cards does not by itself cause the general-use prepaid card to be marketed as a gift card or a gift certificate. For example, the posting of a sign in a store that refers to the availability of gift cards does not by itself constitute the marketing of otherwise exempted general-use prepaid cards that may also be sold in the store along with gift cards or gift certificates, provided that a person acting reasonably under the circumstances would not be led to believe that the sign applies to all cards sold in the store. (*See*, *however*, comment 5(c)-4.ii.)

4. Examples of marketed or labeled as a gift card or gift certificate.

i. The following are examples of marketed or labeled as a gift card or gift certificate:

A. Using the word “gift” or “present” on a card or accompanying material, including documentation, packaging and promotional displays;

B. Representing or suggesting that a card can be given to another person, for example, as a “token of appreciation” or a “stocking stuffer,” or displaying a congratulatory message on the card or accompanying material;

C. Incorporating gift-giving or celebratory imagery or motifs, such as a bow, ribbon, wrapped present, candle, or a holiday or congratulatory message, on a card, accompanying documentation, or promotional material;

ii. The term does not include the following:

A. Representing that a card can be used as a substitute for a checking, savings, or deposit account;

B. Representing that a card can be used to pay for a consumer's health-related expenses—for example, a card tied to a health savings account;

C. Representing that a card can be used as a substitute for travelers checks or cash;

D. Representing that a card can be used as a budgetary tool, for example, by teenagers, or to cover emergency expenses.

5. Reasonable policies and procedures to avoid marketing as a gift card. The exemption for a general-use prepaid card that is reloadable and not marketed or labeled as a gift card or gift certificate in § 235.5(c) applies if a reloadable general-use prepaid card is not marketed or labeled as a gift card or gift certificate and if persons involved in the distribution or sale of the card, including issuers, program managers, and retailers, maintain policies and procedures reasonably designed to avoid such marketing. Such policies and procedures may include contractual provisions prohibiting a reloadable general-use prepaid card from being marketed or labeled as a gift card or gift certificate, merchandising guidelines or plans regarding how the product must be displayed in a retail outlet, and controls to regularly monitor or otherwise verify that the general-use prepaid card is not being marketed as a gift card. Whether a general-use prepaid card has been marketed as a gift card or gift certificate will depend on the facts and circumstances, including whether a reasonable person would be led to believe that the general-use prepaid card is a gift card or gift certificate. The following examples illustrate the application of § 235.5(c):

i. An issuer or program manager of prepaid cards agrees to sell general-purpose reloadable cards through a retailer. The contract between the issuer or program manager and the retailer establishes the terms and conditions under which the cards may be sold and marketed at the retailer. The terms and conditions prohibit the general-purpose reloadable cards from being marketed as a gift card or gift certificate, and require policies and procedures to regularly monitor or otherwise verify that the cards are not being marketed as such. The issuer or program manager sets up one promotional display at the retailer for gift cards and another physically separated display for exempted products under § 235.5(c), including general-purpose reloadable cards, such that a reasonable person would not believe that the exempted cards are gift cards. The exemption in § 235.5(c) applies because policies and procedures reasonably designed to avoid the marketing of the general-purpose reloadable cards as gift cards or gift certificates are maintained, even if a retail clerk inadvertently stocks or a consumer inadvertently places a general-purpose reloadable card on the gift card display.

ii. Same facts as in 5(i), except that the issuer or program manager sets up a single promotional display at the retailer on which a variety of prepaid cards are sold, including store gift cards and general-purpose reloadable cards. A sign stating "Gift Cards" appears prominently at the top of the display. The exemption in § 235.5(c) does not apply with respect to the general-purpose reloadable cards because policies and procedures reasonably designed to avoid the marketing of exempted cards as gift cards or gift certificates are not maintained.

iii. Same facts as in 5(i), except that the issuer or program manager sets up a single promotional multi-sided display at the retailer on which a variety of prepaid card products, including store gift cards and general-purpose reloadable cards are sold. Gift cards are segregated from exempted cards, with gift cards on one side of the display and exempted cards

on a different side of a display. Signs of equal prominence at the top of each side of the display clearly differentiate between gift cards and the other types of prepaid cards that are available for sale. The retailer does not use any more conspicuous signage suggesting the general availability of gift cards, such as a large sign stating "Gift Cards" at the top of the display or located near the display. The exemption in § 235.5(c) applies because policies and procedures reasonably designed to avoid the marketing of the general-purpose reloadable cards as gift cards or gift certificates are maintained, even if a retail clerk inadvertently stocks or a consumer inadvertently places a general-purpose reloadable card on the gift card display.

iv. Same facts as in 5(i), except that the retailer sells a variety of prepaid card products, including store gift cards and general-purpose reloadable cards, arranged side-by-side in the same checkout lane. The retailer does not affirmatively indicate or represent that gift cards are available, such as by displaying any signage or other indicia at the checkout lane suggesting the general availability of gift cards. The exemption in § 235.5(c) applies because policies and procedures reasonably designed to avoid marketing the general-purpose reloadable cards as gift cards or gift certificates are maintained.

6. <u>On-line sales of prepaid cards</u>. Some web sites may prominently advertise or promote the availability of gift cards or gift certificates in a manner that suggests to a consumer that the web site exclusively sells gift cards or gift certificates. For example, a web site may display a banner advertisement or a graphic on the home page that prominently states "Gift Cards," "Gift Giving," or similar language without mention of other available products, or use a web address that includes only a reference to gift cards or gift certificates in the address. In such a case, a consumer acting reasonably under the circumstances could be led to believe that all prepaid products sold on the web site are gift cards or gift certificates. Under these facts, the web site

has marketed all such products as gift cards or gift certificates, and the exemption in § 235.5(c) does not apply to any products sold on the web site.

7. Temporary non-reloadable cards issued in connection with a general-use reloadable card. Certain general-purpose prepaid cards that are typically marketed as an account substitute initially may be sold or issued in the form of a temporary non-reloadable card. After the card is purchased, the cardholder is typically required to call the issuer to register the card and to provide identifying information in order to obtain a reloadable replacement card. In most cases, the temporary non-reloadable card can be used for purchases until the replacement reloadable card arrives and is activated by the cardholder. Because the temporary non-reloadable card may only be obtained in connection with the reloadable card, the exemption in § 235.5(c) applies so long as the card is not marketed as a gift card or gift certificate.

5(d) Exception

1. Additional ATM access. Some debit cards may be used to withdraw cash from ATMs that are not part of the issuer's designated ATM network. An electronic debit card transaction may still qualify for the exemption under §§ 235.5(b) or (c) with a respect to a card for which a fee may be imposed for a withdrawal from an ATM that is outside of the issuer's designated ATM network as long as the card complies with the condition set forth in § 235.5(d)(2) for withdrawals within the issuer's designated ATM network. The condition with respect to ATM fees does not apply to cards that do not provide ATM access.

**§ 235.6 Prohibition on circumvention, evasion, and net compensation**

§ 235.6 In general

1. No applicability to exempt issuers or electronic debit transactions. The prohibition against circumventing or evading the interchange transaction fee restrictions or against net compensation does not apply to issuers or electronic debit transactions that qualify for an exemption under § 235.5 from the interchange transaction fee restrictions.

6(a) Prohibition of circumvention or evasion

1. Finding of circumvention or evasion. A finding of evasion or circumvention will depend on all relevant facts and circumstances. Although net compensation may be one form of circumvention or evasion prohibited under § 235.6(a), it is not the only form.

2. Examples of circumstances that may constitute circumvention or evasion.

The following examples do not constitute per se circumvention or evasion, but may warrant additional supervisory scrutiny to determine whether the totality of the facts and circumstances constitute circumvention or evasion:

i. A payment card network decreases network processing fees paid by issuers for electronic debit transactions by 50 percent and increases the network processing fees charged to merchants or acquirers with respect to electronic debit transactions by a similar amount. Because the requirements of this subpart do not restrict or otherwise establish the amount of fees that a network may charge for its services, the increase in network fees charged to merchants or acquirers and decrease in fees charged to issuers is not a per se circumvention or evasion of the interchange transaction fee standards, but may warrant additional supervisory scrutiny to determine whether the facts and circumstances constitute circumvention or evasion.

ii. An issuer replaces its debit cards with prepaid cards that are exempt from the interchange limits of §§ 235.3 and .4. The exempt prepaid cards are linked to its customers' transaction accounts and funds are swept from the transaction accounts to the prepaid accounts as needed to cover transactions made. Again, this arrangement is not per se circumvention or evasion, but may warrant additional supervisory scrutiny to determine whether the facts and circumstances constitute circumvention or evasion.

6(b) Prohibition of net compensation

1. Net compensation. Net compensation to an issuer through the use of network fees is prohibited.

2. Consideration of payments or incentives provided by the network in net compensation determination.

i. For purposes of the net compensation determination, payments or incentives paid by a payment card network to an issuer with respect to electronic debit transactions or debit card related activities could include, but are not limited to, marketing incentives; payments or rebates for meeting or exceeding a specific transaction volume, percentage share, or dollar amount of transactions processed; or other payments for debit card related activities. For example, signing bonuses paid by a network to an issuer for the issuer's debit card portfolio would also be included in the total amount of payments or incentives received by an issuer from a payment card network with respect to electronic debit transactions. A signing bonus for an entire card portfolio, including credit cards, may be allocated to the issuer's debit card business based on the proportion of the cards or transactions that are debit cards or electronic debit transactions, as appropriate to the situation, for purposes of the net compensation determination.

ii. Incentives paid by the network with respect to multiple-year contracts may be allocated over the life of the contract.

iii. For purposes of the net compensation determination, payments or incentives paid by a payment card network with respect to electronic debit transactions or debit card-related activities do not include interchange transaction fees that are passed through to the issuer by the network, or discounts or rebates provided by the network or an affiliate of the network for issuer-processor services. In addition, funds received by an issuer from a payment card network as a result of chargebacks, fines paid by merchants or acquirers for violations of network rules, or settlements or recoveries from merchants or acquirers to offset the costs of fraudulent transactions or a data security breach do not constitute incentives or payments made by a payment card network.

3. Consideration of fees paid by an issuer in net compensation determination.

i. For purposes of the net compensation determination, fees paid by an issuer to a payment card network with respect to electronic debit transactions or debit card related activities include, but are not limited to, membership or licensing fees, network administration fees, and fees for optional network services, such as risk management services.

ii. For purposes of the net compensation determination, fees paid by an issuer to a payment card network with respect to electronic debit transactions or debit card-related activities do not include network processing fees (such as switch fees and network connectivity fees) or fees paid to an issuer processor affiliated with the network for authorizing, clearing, or settling an electronic debit transaction.

4. Example of circumstances not involving net compensation to the issuer. The following example illustrates circumstances that would not indicate net compensation by the payment card network to the issuer:

i. Because of an increase in debit card transactions that are processed through a payment card network during a calendar year, an issuer receives an additional volume-based incentive payment from the network for that period. Over the same period, however, the total network fees (other than processing fees) the issuer pays the payment card network with respect to debit card transactions also increase so that the total amount of fees paid by the issuer to the network continue to exceed incentive payments by the network to the issuer. Under these circumstances, the issuer does not receive net compensation from the network for electronic debit transactions or debit card related activities.

**§ 235.7 Limitations on payment card restrictions**

1. Application of small issuer, government-administered payment program, and reloadable card exemptions to payment card network restrictions. The exemptions under § 235.5 for small issuers, cards issued pursuant to government-administered payment programs, and certain reloadable prepaid cards do not apply to the limitations on payment card network restrictions. For example, debit cards for government-administered payment programs, although exempt from the restrictions on interchange transaction fees, are subject to the requirement that electronic debit transactions made using such cards must be capable of being processed on at least two unaffiliated payment card networks and to the prohibition on inhibiting a merchant's ability to determine the routing for electronic debit transactions.

7(a) Prohibition on network exclusivity

1. Scope of restriction. Section 235.7(a) requires a debit card subject to the regulation to be enabled on at least two unaffiliated payment card networks. This paragraph does not, however, require an issuer to have two or more unaffiliated networks available for each method of cardholder authentication. For example, it is sufficient for an issuer to issue a debit card that operates on one signature-based card network and on one PIN-based card network, as long as the two card networks are not affiliated. Alternatively, an issuer may issue a debit card that is accepted on two unaffiliated signature-based card networks or on two unaffiliated PIN-based card networks. See also comment 7(a)-7.

2. Permitted networks. i. A smaller payment card network could be used to help satisfy the requirement that an issuer enable two unaffiliated networks if the network was willing to expand its coverage in response to increased merchant demand for access to its network and it meets the other requirements for a permitted arrangement, including taking steps reasonably designed to enable it to process the electronic debit transactions that it would reasonably expect to be routed to it. If, however, the network's policy or practice is to limit such expansion, it would not qualify as one of the two unaffiliated networks.

ii. A payment card network that is accepted only at a limited category of merchants (such as a particular grocery store chain, merchants located in a particular shopping mall, or a single class of merchants, such as grocery stores or gas stations) would not satisfy the rule.

iii. One of the steps a network can take to form a reasonable expectation of transaction volume is to consider factors such as the number of cards expected to be issued that are enabled on the network and expected card usage patterns.

3. Examples of prohibited network restrictions on an issuer's ability to contract. The following are examples of prohibited network restrictions on an issuer's ability to contract with other payment card networks:

i. Network rules or contract provisions limiting or otherwise restricting the other payment card networks that may be enabled on a particular debit card, or network rules or contract provisions that specify the other networks that may be enabled on a particular debit card.

ii. Network rules or guidelines that allow only that network's (or its affiliated network's) brand, mark, or logo to be displayed on a particular debit card, or that otherwise limit the ability of brands, marks, or logos of other payment card networks to appear on the debit card.

4. Network logos or symbols on card not required. Section 235.7(a) does not require that a debit card display the brand, mark, or logo of each payment card network over which an electronic debit transaction may be processed. For example, this rule does not require a debit card that is enabled for two or more unaffiliated payment card networks to bear the brand, mark, or logo for each card network.

5. Voluntary exclusivity arrangements prohibited. Section 235.7(a) requires the issuance of debit cards that are enabled on at least two unaffiliated payment card networks, even if the issuer is not subject to any rule of, or contract or other agreement with, a payment card network requiring that all or a specified minimum percentage of electronic debit transactions be processed on the network or its affiliated networks.

6. Affiliated payment card networks. Section 235.7(a) does not prohibit an issuer from including an affiliated payment card network among the networks that may process an electronic debit transaction with respect to a particular debit card, as long as at least two of the networks that are enabled on the card are unaffiliated. For example, an issuer may offer debit cards that

are accepted on a payment card network for signature debit transactions and on an affiliated payment card network for PIN debit transactions as long as those debit cards may also be accepted on another unaffiliated payment card network.

7. Application of rule regardless of form factor. The network exclusivity provisions in § 235.7(a) require that all debit cards be enabled on at least two unaffiliated payment card networks for electronic debit transactions, regardless of whether the debit card is issued in card form. This applies to any supplemental device, such as a fob or token, or chip or application in a mobile phone, that is issued in connection with a plastic card, even if that plastic card fully complies with the rule.

7(b) Prohibition on routing restrictions

1. Relationship to the network exclusivity restrictions. An issuer or payment card network is prohibited from inhibiting a merchant's ability to route or direct an electronic debit transaction over any of the payment card networks that the issuer has enabled to process an electronic debit transaction for that particular debit card. This rule does not permit a merchant to route the transaction over a network that the issuer did not enable to process transactions using that debit card.

2. Examples of prohibited merchant restrictions. The following are examples of issuer or network practices that would inhibit a merchant's ability to direct the routing of an electronic debit transaction that are prohibited under § 235.7(b):

i. Prohibiting a merchant from encouraging or discouraging a cardholder's use of a particular method of debit card authorization, such as rules prohibiting merchants from favoring a cardholder's use of PIN debit over signature debit, or from discouraging the cardholder's use of signature debit.

ii. Establishing network rules or designating issuer priorities directing the processing of an electronic debit transaction on a specified payment card network or its affiliated networks, or directing the processing of the transaction away from a specified network or its affiliates, except as a default rule in the event the merchant, or its acquirer or processor, does not designate a routing preference, or if required by state law.

iii. Requiring a specific payment card network based on the type of access device provided to the cardholder by the issuer.

3. Merchant payments not prohibited. A payment card network does not restrict a merchant's ability to route transactions over available payment card networks in violation of § 235.7(b) by offering payments or other incentives to encourage the merchant to route electronic debit card transactions to the network for processing.

4. Real-time routing decision not required. A merchant need not make network routing decisions on a transaction-by-transaction basis. A merchant and its acquirer or processor may agree to a pre-determined set of routing choices that apply to all electronic debit transactions that are processed by the acquirer or processor on behalf of the merchant.

5. No effect on network rules governing the routing of subsequent transactions. Section 235.7 does not supersede a network rule that requires a chargeback or return of an electronic debit transaction to be processed on the same network that processed the original transaction.

7(c) Effective date

1. Health care and employee benefit cards. Section 235.7(c)(1) delays the effective date of the network exclusivity provisions for certain debit cards issued in connection with a health care or employee benefit account to the extent such cards use (even if not required) transaction

substantiation or qualification authorization systems at point of sale to verify that the card is only used for eligible goods and services for purposes of qualifying for favorable tax treatment under Internal Revenue Code requirements. Debit cards that may qualify for the delayed effective date include, but may not be limited to, cards issued in connection with flexible spending accounts established under section 125 of the Internal Revenue Code for health care related expenses and health reimbursement accounts established under section 105 of the Internal Revenue Code.

**§ 235.8 Reporting Requirements and Record Retention**

[reserved]

**§ 235.9 Administrative Enforcement**

[reserved]

**§ 235.10 Effective Date**

[reserved]

By order of the Board of Governors of the Federal Reserve System, June 29, 2011.

Jennifer J. Johnson

Secretary of the Board.