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Part II

Federal Reserve System

12 CFR Part 235

Debit Card Interchange Fees and Routing; Proposed Rule

FEDERAL RESERVE SYSTEM

12 CFR Part 235

[Regulation II; Docket No. R–1404]

RIN 7100–AD63

Debit Card Interchange Fees and Routing

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Notice of proposed rulemaking.

SUMMARY: The Board is requesting public comment on proposed new Regulation II, Debit Card Interchange Fees and Routing, which: establishes standards for determining whether an interchange fee received or charged by an issuer with respect to an electronic debit transaction is reasonable and proportional to the cost incurred by the issuer with respect to the transaction; and prohibits issuers and networks from restricting the number of networks over which an electronic debit transaction may be processed and from inhibiting the ability of a merchant to direct the routing of an electronic debit transaction to any network that may process such transactions. With respect to the interchange fee standards, the Board is requesting comment on two alternatives that would apply to covered issuers: an issuer-specific standard with a safe harbor and a cap; or a cap applicable to all such issuers. The proposed rule would additionally prohibit circumvention or evasion of the interchange fee limitations (under both alternatives) by preventing the issuer from receiving net compensation from the network (excluding interchange fees passed through the network). The Board also is requesting comment on possible frameworks for an adjustment to interchange fees for fraud-prevention costs. With respect to the debit-card routing rules, the Board is requesting comment on two alternative rules prohibiting network exclusivity: one alternative would require at least two unaffiliated networks per debit card, and the other would require at least two unaffiliated networks for each type of transaction authorization method. Under both alternatives, the issuers and networks would be prohibited from inhibiting a merchant's ability to direct the routing of an electronic debit transaction over any network that may process such transactions.

DATES: Comments must be submitted by February 22, 2011.

ADDRESSES: You may submit comments, identified by Docket No. R–1404 and RIN No. 7100 AD63, by any of the following methods:

Agency Web site: http://www.federalreserve.gov. Follow the instructions for submitting comments at *http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm.*

Federal eRulemaking Portal:http://www.regulations.gov. Follow the instructions for submitting comments.

E-mail: regs.comments@federalreserve.gov. Include the docket number in the subject line of the message.

Fax: (202) 452–3819 or (202) 452–3102.

Mail: Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551.

All public comments are available from the Board's Web site at *http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm* as submitted, unless modified for technical reasons. Accordingly, your comments will not be edited to remove any identifying or contact information.

Public comments may also be viewed electronically or in paper in Room MP–500 of the Board's Martin Building (20th and C Streets, NW.) between 9 a.m. and 5 p.m. on weekdays.

FOR FURTHER INFORMATION CONTACT: Dena Milligan, Attorney (202/452–3900), Legal Division, David Mills, Manager and Economist (202/530–6265), Division of Reserve Bank Operations & Payment Systems, Mark Manuszak, Senior Economist (202/721–4509), Division of Research & Statistics, or Ky Tran-Trong, Counsel (202/452–3667), Division of Consumer & Community Affairs; for users of Telecommunications Device for the Deaf (TDD) only, contact (202/263–4869); Board of Governors of the Federal Reserve System, 20th and C Streets, NW., Washington, DC 20551.

SUPPLEMENTARY INFORMATION

Background

I. Section 1075 of the Dodd-Frank Act—Overview

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") (Pub. L. 111–203, 124 Stat. 1376 (2010)) was enacted on July 21, 2010. 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.[1]

EFTA Section 920 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.[2] That section authorizes the Board to prescribe regulations regarding any interchange transaction fee that an issuer may receive or charge with respect to an electronic debit transaction and 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.

Under EFTA Section 920, the Board may allow for an adjustment to an interchange transaction fee to account for an issuer's costs in preventing fraud, provided the issuer complies with the standards to be established by the Board relating to fraud-prevention activities. EFTA Section 920 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 and is not used to circumvent or evade the restrictions on interchange transaction fees.

EFTA Section 920 exempts 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 government-administered payment programs and reloadable, general-use prepaid cards not marketed or labeled as a gift card or certificate. EFTA Section 920 provides, however, that beginning July 21, 2012, the exemptions from the interchange transaction fee restrictions will not apply for transactions made using debit cards provided pursuant to a government-administered payment program or made using certain reloadable, general-use prepaid cards if the cardholder may be charged either an overdraft fee or a fee for the first

[1] Section 920 is codified in 15 U.S.C. 1693o–2. As discussed in more detail below, interchange transaction fees (or "interchange fees") are fees established by a payment card network, charged to the merchant acquirer and received by the card issuer for its role in transaction.

[2] Electronic debit transaction (or "debit card transaction") means the use of a debit card, including a general-use prepaid card, by a person as a form of payment in the United States.

withdrawal each month from ATMs in the issuer's designated ATM network.

In addition to rules regarding restrictions on interchange transaction fees, EFTA Section 920 also requires the Board to prescribe certain rules related to the routing of debit card transactions. First, EFTA Section 920 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.

EFTA Section 920 requires the Board to establish interchange fee standards and rules prohibiting circumvention or evasion no later than April 21, 2011. These interchange transaction fee rules will become effective on July 21, 2011. EFTA Section 920 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 rules.

II. Overview of the Debit Card Industry

Over the past several decades, there have been significant changes in the way consumers make payments in the United States. The use of checks 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). Debit card usage, in particular, has increased markedly during that same period. After a long period of slow growth during the 1980s and early 1990s, debit card transaction volume began to grow very rapidly in the mid-1990s. 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. Debit cards are accepted at about 8 million merchant locations in the United States. In 2009, debit card transactions represented almost half of total third-party debits to deposit accounts, while approximately 30 percent of total third-party debits to deposit accounts were made by checks.[3]

In general, there are two types of debit card transactions: PIN (personal identification number)-based and signature-based.[4] 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 one 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. In the current environment, certain transactions cannot readily be accommodated on PIN-based, single-message systems, such as transactions for hotel stays or car rentals, where the exact amount of the transaction is not known at the time of authorization. In addition, PIN debit transactions generally are not accepted for Internet transactions. Overall, roughly one-quarter of the merchant locations in the United States that accept debit cards have the capability to accept PIN-based debit transactions. According to the Board's survey of covered card issuers, roughly 70 percent of debit cards outstanding (including prepaid cards) support both PIN- and signature-based transactions (87 percent, excluding prepaid cards).[5]

Networks that process debit card transactions exhibit two main organizational forms, often referred to as three-party and four-party systems.[6] 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).[7] The network coordinates the transmission of information between the issuing and acquiring sides of the market (authorization and clearing) and the interbank monetary transfers (settlement).[8]

In a typical three-party system, the network itself acts as both issuer and acquirer. Thus, the three parties involved in a transaction are the cardholder, the merchant, and the network. Three-party systems are also referred to as "closed," because the issuer and acquirer are generally the same institution—they have, thus, tended to be closed to outside participants. The three-party model is used for some prepaid card transactions, but not for other debit card transactions.

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 and the cardholder's account information is sent from the merchant to the acquirer to the network, which forwards the request to the card-issuing institution.[9] 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 authorizing (or declining) the transaction is returned to the merchant via the reverse path.

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 cardholders' accounts based on these clearing messages. The network calculates and communicates to each issuer and acquirer its net debit or credit position to settle the day's transactions. The interbank settlement generally is effected through a settlement account at a commercial bank, or through automated clearinghouse (ACH) transfers. The acquirer credits the merchant for the value of its transactions, less the merchant discount, as discussed below.

There are various fees associated with debit card transactions. The interchange fee is set by the relevant network and paid by the merchant acquirer to the issuer. Switch fees are charged by the network to acquirers and issuers to compensate the network for its role in

[3] 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. A summary of the 2010 Federal Reserve Payments Study is available at *http://www.frbservices.org/files/communications/pdf/press/2010_payments_study.pdf.*

[4] 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."

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

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

[7] Throughout this proposed rule, the term "bank" often is used to refer to depository institutions.

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

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

processing the transaction.[10] The merchant acquirer charges the merchant a merchant discount—the difference between the face value of a transaction and the amount the merchant 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.

When PIN debit networks were first introduced, some of them structured interchange fees in a manner similar to ATM interchange fees.[11] For ATM card 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, all PIN debit interchange fees were paid by acquirers to card issuers.[12]

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.,* 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 type of merchant (*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 fixed component fees, *ad valorem* fees, and caps on these 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, the 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)[13] to gain increased acceptance in those markets. Until 2003, signature debit interchange fees were generally around the same level as credit card interchange fees and have generally been significantly higher than those for PIN debit card transactions. PIN debit fees began to increase in the early 2000s, while signature debit fees declined in late 2003 and early 2004.[14] 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 between network participants. Although the network rules explicitly govern the issuers and acquirers, merchants and processors also may be required to comply with the network 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.

III. Outreach and Information Collection

A. Summary of Outreach

Since enactment of the Dodd-Frank Act, Board staff has held numerous meetings with debit card issuers, payment card networks, merchant acquirers, merchants, industry trade associations, and consumer groups. In general, those parties provided information regarding electronic debit transactions, including processing flows for electronic debit transactions, structures and levels of current interchange transaction fees and other fees charged by the networks, fraud-prevention activities performed by various parties to an electronic debit transaction, fraud losses related to electronic debit transactions, routing restrictions, card-issuing arrangements, and incentive programs for both merchants and issuers. Interested parties also provided written submissions.[15]

B. Surveys

On September 13, 2010, the Board distributed three surveys to industry participants (an issuer survey, a network survey, and a merchant acquirer survey) designed to gather information to assist the Board in developing this proposal. Industry participants, including payment card networks, trade groups and individual firms from both the banking industry and merchant community, commented on preliminary versions of the issuer and network surveys, through both written submissions and a series of drop-in calls. In response to the comments, the two surveys were modified, as appropriate, and an additional survey of merchant acquirers was developed.[16]

The card issuer survey was distributed to 131 financial organizations that, together with affiliates, have assets of $10 billion or more.[17] The Board received 89

[10] A variety of other network fees may be collected by the network from the issuer or acquirer.

[11] 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.

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

[13] 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.

[14] This decline followed the settlement of litigation surrounding signature debit cards. *See In re: Visa Check/MasterMoney Antitrust Litigation,* 192 F.R.D. 68 (F.D.N.Y. 2000).

[15] The meeting summaries and written submissions are available on the Regulatory Reform section of the Board's Web site, available at *http://www.federalreserve.gov/newsevents/reform_meetings.htm.*

[16] Documentation and forms for the card issuer, payment card network, and merchant acquirer surveys are respectively available at *http://www.federalreserve.gov/newsevents/files/card_issuer_survey_20100920.pdf, http://www.federalreserve.gov/newsevents/files/payment_card_network_survey_20100920.pdf,* and *http://www.federalreserve.gov/newsevents/files/merchant_acquirer_survey_20100920.pdf.*

[17] These institutions include bank and thrift holding companies with assets of at least $10 billion; independent commercial banks, thrifts, and credit unions with assets of at least $10 billion; and FDIC-insured U.S. branches and agencies of foreign banking organizations with worldwide assets of at least $10 billion. Assets were computed 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

responses to the survey. An additional 13 organizations informed the Board that they do not have debit card programs. Three organizations that issued a small number of cards declined to participate in the survey. The Board did not receive any communication from the other 26 organizations. The network survey was distributed to the 14 networks believed to process debit card transactions, all of which provided responses. The merchant acquirer survey was distributed to the largest nine merchant acquirers/processors, all of whom responded to the survey.

Information Requested and Summary Results

In general, the surveys requested information on signature debit, PIN debit and prepaid card operations and, for each card type, the costs associated with those card types, interchange fees and other fees established by networks, fraud losses, fraud-prevention and data-security activities, network exclusivity arrangements and debit-card routing restrictions. The Board compiled the survey responses in a central database, and reviewed the submissions for completeness, consistency, and anomalous responses. As indicated above, the response rates for the three surveys were high; however, 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 granularity requested in the surveys. In addition, there were inconsistencies in some data that were reported within individual responses and across responses. Therefore, each of the summary statistics reported below may be based on a subset of the responses received for each of the three surveys. The reporting period for each survey was calendar year 2009, unless otherwise noted.

Card use. The networks reported that there were approximately 37.7 billion debit and prepaid card transactions in 2009, valued at over $1.45 trillion, with an average value of $38.58 per transaction.[18] [19] [20] Responding issuers reported that, on average, they had 174 million debit cards and 46 million prepaid cards outstanding during 2009. Eighty-seven percent of debit cards and 25 percent of prepaid cards were enabled for use on both signature and PIN networks. Four percent of debit cards and 74 percent of prepaid cards were enabled for use on signature networks only. Finally, 9 percent of debit cards and 1 percent of prepaid cards were enabled for use on PIN networks only. Responding acquirers reported that 6.7 million merchant locations were able to accept signature debit cards and 1.5 million were able to accept PIN debit cards.[21]

Interchange fees. Networks reported that debit and prepaid interchange fees totaled $16.2 billion in 2009.[22] The average interchange fee for all debit transactions was 44 cents per transaction, or 1.14 percent of the transaction amount. The average interchange fee for a signature debit transaction was 56 cents, or 1.53 percent of the transaction amount. The average interchange fee for a PIN debit transaction was significantly lower than that of a signature debit transaction, at 23 cents per transaction, or 0.56 percent of the transaction amount. Prepaid card interchange fees were similar to those of signature debit, averaging 50 cents per transaction, or 1.53 percent of the transaction amount.[23]

Processing costs. Issuers reported their per-transaction processing costs, which are those costs related to authorization, clearance, and settlement of a transaction.[24] The median per-transaction total processing cost for all types of debit and prepaid card transactions was 11.9 cents.[25] The median per-transaction variable processing cost was 7.1 cents for all types of debit and prepaid card transactions.[26] The median per-transaction network processing fees were 4.0 cents for all types of debit and prepaid card transactions.[27]

Network fees. Networks reported charging two types of per-transaction fees: processing and non-processing fees. Networks also reported charging fees other than on a per-transaction basis. Networks charged issuers a total of $2.3 billion in fees and charged acquirers a total of $1.9 billion in fees. In general, the proportion of fees paid by each party varied by network type. Aggregating these fees across all debit and prepaid card transactions, the average network fee attributable to each transaction was 6.5 cents for issuers and 5.0 cents for acquirers. The average network fee attributable to each signature debit transaction was 8.4 cents for issuers and 5.7 cents for acquirers. Thus, about 60 percent of signature debit network fees were paid by issuers and 40 percent by acquirers. For PIN debit transactions, the average network fee attributable to each transaction was 2.7 cents for issuers and 3.7 cents for acquirers. Thus, about 42 percent of PIN debit network fees were paid by issuers and 58 percent by acquirers. As noted above, these fees include per-transaction processing fees and non-processing fees, as well as other fees. Based on data reported by responding issuers, signature debit network processing fees were 3.0 cents per transaction on average and PIN debit network processing fees were 1.6¢ per transaction on average.

Networks also reported providing discounts and incentives to issuers and acquirers/merchants. Issuers were provided discounts and incentives totaling $0.7 billion, or an average of 2.0 cents per transaction, while acquirers

structure of banking organizations was established using the FFIEC's National Information Center structure database.

[18] These data do not include ATM transactions. Responding issuers accounted for approximately 60 percent of total debit and prepaid card transactions in 2009. The acquirers surveyed handled about 95 percent of these total transactions.

[19] Of these 37.7 billion transactions, 22.5 billion were signature debit transactions, with a total value of $837 billion and an average value of $37.15 per transaction; 14.1 billion were PIN debit transactions with a total value of $584 billion and an average value of $41.34 per transaction; and 1.0 billion were prepaid card transactions, with a total value of $33 billion and an average value of $32.54 per transactions. Of the 37.7 billion transactions, 90 percent were card-present transactions. Eighty-six percent of signature debit and 97 percent of PIN debit transactions were card-present transactions.

[20] The recently released 2010 Federal Reserve Payments Study reported 6.0 billion prepaid card transactions in 2009, of which 1.3 billion were general purpose prepaid card transactions and 4.7 billion were private label prepaid card and electronic benefit transfer card transactions that were not included in the Board survey.

[21] These numbers differ from the estimates that were otherwise provided to the Board by major payment card networks, card issuers, and merchant acquirers.

[22] Of the $16.2 billion in 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 responding issuers reported receiving $11.0 billion, or about 68 percent of total interchange fees.

[23] The network survey also requested information on historical interchange fees. Not all networks reported historical interchange fees back to 1990. However, from 1990 to 2009, it appears that interchange fees for signature debit transactions generally were around 1.5 percent of transaction value. Based on other industry resources, interchange fees on PIN debit transactions in the late 1990s were about 7 cents per transaction (Debit Card Directory, 1995–1999). Therefore, it appears that these fees rose significantly during the 2000s.

[24] Unlike other statistics in this discussion, the Board discusses cost information using percentiles within this **Federal Register** Notice to avoid having summary measures distorted by extreme values in the sample cost data.

[25] By transaction type, the median total per-transaction processing cost was 13.7 cents for signature debit, 7.9 cents for PIN debit and 63.6 cents for prepaid cards.

[26] By transaction type, the median variable per-transaction processing cost was 6.7 cents for signature debit, 4.5 cents for PIN debit, and 25.8 cents for prepaid cards.

[27] By transaction type, the median per-transaction network processing fees were 4.7 cents for signature debit, 2.1 cents for PIN debit, and 6.9 cents for prepaid cards.

were provided discounts and incentives of $0.3 billion, or an average of 0.9 cents per transaction. Signature debit networks provided average incentives and discounts of 2.6 cents per transaction to issuers and 1.2 cents per transaction to acquirers. Thus, 69 percent of signature debit network incentives and discounts were provided to issuers and 31 percent to acquirers. PIN debit networks provided average incentives and discounts of 0.7 cents per transaction to issuers and 0.5 cents per transaction to acquirers. Thus, 61 percent of PIN debit network incentives and discounts were provided to issuers and 39 percent to acquirers.

Discounts and incentives effectively reduce the per-transaction amount of network fees each party pays. After adjusting for discounts and incentives, the average net network fee per transaction is 4.5 cents for issuers and 4.1 cents for acquirers.[28] For signature debit transactions, the average net network fee per transaction is 5.9 cents for issuers and 4.5 cents for acquirers. Thus, 57 percent of net network fees on signature networks were paid by issuers and 43 percent by acquirers. For PIN debit networks, the average net network fee per transaction is 1.9 cents for issuers and 3.2 cents for acquirers. Thus, 37 percent of net network fees on PIN debit networks were paid by issuers and 63 percent by acquirers.

Fraud data. Survey responses on fraud occurrence, fraud losses, and fraud-prevention and data-security costs are discussed in section IV of this notice.

Exclusivity arrangements and routing restrictions. The surveys also included a number of questions about exclusivity arrangements and transaction routing procedures. Respondents reported that there are arrangements, either rules-based or contractual, under which transactions must be routed exclusively over specific networks or that commit issuers to meet certain volume and dollar thresholds for transactions on those networks. Respondents also reported that they receive incentives under these arrangements, which for issuers take the form lower network fees, signing bonuses, and marketing and development funds. For acquirers, the incentives typically take the form of lower network fees.

Summary of Proposal

Reasonable and proportional fees. The Board is requesting 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. Alternative 1 adopts issuer-specific standards with a safe harbor and a cap. In contrast, Alternative 2 adopts a cap that is applicable to all covered issuers.

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 any interchange fee in excess of its allowable costs through any network. An issuer's allowable costs would be those costs that are attributable to the issuer's role in authorization, clearance, and settlement of the transaction and that 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 on the amount of any interchange fee an issuer could receive or charge, regardless of the issuer's allowable cost calculation. The Board proposes to set this cap at an initial level of 12 cents per transaction. 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, in which case the issuer would not need to determine its maximum interchange fee based on allowable costs. The Board proposes to set the safe harbor amount at an initial level of 7 cents per transaction. Therefore, under Alternative 1, each payment card network would have the option of setting interchange fees either (1) at or below the safe harbor or (2) at an amount for each issuer such that the interchange fee for that issuer does not exceed the issuer's allowable costs, up to the cap.

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.

Fraud-prevention adjustment. The Board's proposal requests comment on two general approaches to the fraud-prevention adjustment framework and asks several questions related to the two alternatives. One approach focuses on implementation of major innovations that would likely result in substantial reductions in total, industry-wide fraud losses. The second approach focuses 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. At this time, the Board is not proposing a specific adjustment to the amount of an interchange fee for an issuer's fraud-prevention costs. After considering the comments received, the Board expects to develop a specific proposal on the fraud adjustment for public comment.

Exemptions. The Board's proposed rule exempts issuers that, together with affiliates, have assets of less than $10 billion. The Board's proposed rule also exempts electronic debit transactions made using debit cards issued under government-administered programs or made using certain reloadable prepaid cards. These exempt issuers or transactions would not be subject to the interchange transaction fee restrictions. The exemptions do not apply to the proposed rule's provisions regarding network exclusivity and routing restrictions.

Prohibition on circumvention or evasion. In order to prevent circumvention or evasion of the limits on the amount of interchange fees that issuers receive from acquirers, the proposed rule would 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.

Limitation on debit card restrictions. The Board is requesting comment on two alternative approaches to implement 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 carried 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

[28] Net network fees paid by issuers and acquirers were calculated by subtracting incentives and discounts provided from network fees paid.

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 carried to less than two unaffiliated networks for each method of authorization the cardholder may select. Under this alternative, an issuer that used both signature- and PIN-based authorization would have to enable its debit cards with two unaffiliated signature-based networks and two unaffiliated PIN-based networks.

Transaction routing. The Board proposes 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.

Scope of Rule

In general, the Board's proposed rule covers debit card transactions (not otherwise exempt) that debit an account. The Board's proposed rule also covers both three-party and four-party systems. Throughout the proposal, the Board generally describes the interchange fee standards and the network exclusivity and routing rules in a manner that most readily applies to debit card transactions initiated at the point of sale for the purchase of goods and services and debit card transactions carried over four-party networks. The scope of the proposed rule, however, covers three-party networks and could cover ATM transactions and networks. The Board requests comment on the application of the proposed rule to ATM transactions and ATM networks, as well as to three-party networks.

Coverage of ATM transactions and networks. The Board requests comment on whether ATM transactions and ATM networks should be included within the scope of the rule. Although the statute does not expressly include ATM transactions within its scope, EFTA Section 920's definitions of "debit card," "electronic debit transaction," and "payment card network" could be read to bring ATM transactions within the coverage of the rule. Specifically, most ATM cards can be used to debit an asset account. It could also be argued that an ATM operator accepts the debit card as form of payment to carry out the transaction, so the ATM network could be covered by the statutory definition of a "payment card network."

Under EFTA Section 920(c)(8), the term "interchange transaction fee" is defined as a fee charged "for the purpose of compensating an issuer." Traditionally, however, the interchange fee for ATM transactions is paid by the issuer and flows to the ATM operator. Thus, the proposed interchange transaction fee standards would not apply to ATM interchange fees and would not constrain the current level of such fees.[29]

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. As discussed below, in point-of-sale transactions, these provisions improve the ability of a merchant to select the network that *minimizes* its cost (particularly the cost associated with interchange fees) and otherwise provides the most advantageous terms. In the case of ATM transactions, however, the exclusivity and routing provisions would give the ATM operator, which is receiving the ATM interchange fee, the ability to select the network that *maximizes* that fee. Therefore, coverage of ATM networks under the rule may result in very different economic incentives than coverage of point-of-sale debit card networks.

If ATM networks and ATM transactions are included within the scope of the rule, the Board requests comment on how to implement the network exclusivity provision. For example, if the Board requires two unaffiliated networks for each authorization method, should it explicitly require an issuer to ensure that ATM transactions may be routed over at least two unaffiliated networks? Should the Board state that one point-of-sale debit network and one ATM-only network would not satisfy the exclusivity prohibition under either proposed alternative? The Board also specifically requests comment on the effect of treating ATM transactions as "electronic debit transactions" under the rule on small issuers, as well as the cardholder benefit, if any, of such an approach.

Coverage of three-party systems. The Board also requests comment on the appropriate application of the interchange fee standards to electronic debit transactions carried over three-party systems. In a three-party payment system, the payment card network typically serves both as the card issuer and the merchant acquirer for purposes of accepting payment on the network.[30] In this system, there is no explicit interchange fee. Instead, the merchant directly pays a merchant discount to the network. The merchant discount typically is equivalent to the sum of the interchange fee, the network switch fee, other acquirer costs, and an acquirer markup that would typically be imposed in a four-party system.

Both the statutory and proposed definition of "interchange transaction fee" would cover the part of the merchant discount in a three-party system that is used to compensate the network for its role as issuer. If a three-party network apportioned its entire merchant discount to its roles as network or merchant acquirer, however, the interchange fee would, in effect, be zero. This outcome, coupled with the fact the statute does not restrict fees an acquirer charges a merchant, may present practical difficulties in limiting the amount of a merchant discount charged in a three-party network. The Board requests comment on the appropriate way to treat three-party networks and on any specific clarifications with respect to such fees that should be provided in the regulation.

In addition, the Board requests comment on how the network exclusivity and routing provisions should be applied to three-party systems. If the limitations on payment card network restrictions under § 235.7 were applied to a three-party system, debit cards issued by the network would be required to be capable of being routed 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. For example, under Alternative A for the network exclusivity provisions, the payment card network would be required to add an unaffiliated network and arrange for the unaffiliated debit network to carry debit transactions, for ultimate routing

[29] The rule's interchange fee standard could become a constraint in the future if ATM interchange fees begin to flow in the same direction as point-of-sale debit card transactions, as was the case for interchange fees of certain PIN debit networks in the 1990s.

[30] In addition, under a three-party system, outside processors generally are not authorized by the network to acquire transactions from merchants. Although outside processors may provide some processing services to the merchant, the network is ultimately the acquirer for every transaction.

to the contracting network, which may result in more circuitous routing that would otherwise be the case. Under Alternative B, which requires at least two unaffiliated payment card networks for each method of authorization, the payment card network would be required to add at least one unaffiliated signature debit network for a signature-only debit card. In addition, if the debit card had PIN debit functionality, the card would also have to be accepted on at least two unaffiliated PIN debit networks.

The Board recognizes 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. Nonetheless, the statute does not provide any apparent basis for excluding three-party systems from the scope of the provisions of EFTA Section 920(b). The Board requests comment on all aspects of applying the proposed rule to three-party payment systems, including on any available alternatives that could minimize the burden of compliance on such systems.

Section-by-Section Analysis

I. Sec. 235.1 Authority and purpose

This section sets forth the authority and purpose for the proposed rule.

II. Sec. 235.2 Definitions

The proposed rule provides definitions for many of the terms used in the rule. As noted throughout this section, many of the definitions follow the EFTA's definitions. The proposed rule also provides definitions for terms not defined in EFTA Section 920. Some of these definitions are based on existing statutory or regulatory definitions, while others are based on terminology in the debit card industry. The Board requests comment on all of the terms and definitions set out in this section. In particular, the Board requests comment on any terms used in the proposed rule that a commenter believes are not sufficiently clear or defined.

A. Sec. 235.2(a) Account

EFTA Section 920(c) defines the term "debit card" in reference to a card, or other payment code or device, that is used "to debit an asset account (regardless of the purpose for which the account is established) * * *." That section, however, does not define the terms "asset account" or "account." 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 end 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." [31]

Similar to EFTA Section 903(2), proposed § 235.2(a) defines "account" to include a transaction account (which includes a demand deposit), savings, or other asset account. The proposed definition, however, differs from EFTA Section 903(2) because EFTA Section 920(c) does not restrict the term debit card to those cards, or other payment codes or devices, that debit accounts established for a particular purpose. Accordingly, the proposed definition includes both an account established primarily for personal, family, or household purposes and an account established for business purposes. For the same reason, the proposed definition of "account" includes an account held by a financial institution under a *bona fide* trust arrangement. These distinctions from the EFTA Section 903(2)'s definition are clarified in proposed comment 2(a)–1.

The proposed definition of "account" is limited to accounts that are located in the United States. The Board does not believe it is appropriate to apply EFTA Section 920's limitations to foreign issuers or accounts, absent a clear indication from Congress to do so.

B. Sec. 235.2(b) Acquirer

Proposed § 235.2(b) defines the term "acquirer." Within the debit card industry, there are numerous models for acquiring transactions from merchants, and the term "acquirer" may not always be used to refer to the entity that holds a merchant's account. In some acquiring relationships, an institution performs all the functions of the acquirer (*e.g.,* signing up and underwriting merchants, processing payments, receiving and providing settlement for the merchants' transactions, and other account maintenance). In other acquiring relationships, an institution performs all the functions of the acquirer except for settling the merchant's transactions with both the merchant and the network.

The Board is proposing to limit the term "acquirer" to entities that "acquire" (or buy) the electronic debit transactions from the merchant. Proposed § 235.2(b) defines "acquirer" as a person that "contracts directly or indirectly with a merchant to receive and provide settlement for the merchant's electronic debit transactions over a payment card network." Proposed § 235.2(b) limits the term to those entities serving a financial institution function with respect to the merchant, as distinguished from a processor function, by stipulating that the entity "receive and provide settlement for the merchant's" transactions. Proposed § 235.2(b) also explicitly excludes entities that solely process transactions for the merchant from the term "acquirer."

Proposed § 235.2(b), however, takes into consideration the fact that the degree of involvement of the entity settling with the merchant varies under different models by defining "acquirer" as a person that "contracts directly or indirectly with a merchant." *See* proposed comment 2(b)–1.

C. Sec. 235.2(c) Affiliate and § 235.2(e) Control

Proposed §§ 235.2(c) and (e) define the terms "affiliate" and "control." EFTA Section 920(c)(1) defines the term "affiliate" as "any company that controls, is controlled by, or is under common control with another company." The proposed rule incorporates the EFTA's definition of "affiliate."

Although the EFTA's definition of affiliate is premised on control, the EFTA does not define that term. The Board is proposing to adopt a definition of "control" that is consistent with definitions of that term in other Board regulations.[32]

D. Sec. 235.2(d) Cardholder

Proposed § 235.2(d) defines the term "cardholder" as the person to whom a debit card is issued. Proposed comment 2(d) clarifies that if an issuer issues a debit card for use to debit a transaction, savings, or other similar asset account, the cardholder usually will be the account holder. In some cases, however, such as with a business account, there may be multiple persons who have been issued debit cards and are authorized to use those debit cards to debit the same account. Each employee issued a card would be considered a cardholder. In the case of a prepaid card, the cardholder is the person that purchased the card or a person who received the card from the purchaser. *See* proposed comment 2(d)–1.

[31] 15 U.S.C. 1693a.

[32] *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).

F. Sec. 235.2(f) Debit Card and § 235.2(i) General-Use Prepaid Card

Debit Card (§ 235.2 (f))

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." The term includes a general-use prepaid card, as that term was previously defined by the gift card provisions of the Credit Card Accountability, Responsibility and Disclosure Act of 2009 (Credit Card Act).[33] The statute excludes paper checks from the definition of "debit card."

Proposed § 235.2(f) defines the term "debit card" and generally tracks the definition set forth in EFTA Section 920. Thus, proposed § 235.2(f)(1) generally 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 account, regardless of whether authorization is based on signature, personal identification number (PIN), or other means." In addition, the term applies regardless of whether the issuer holds the underlying account. This is consistent with the statutory definition of "debit card" which does not require that an issuer also hold the account debited by the card, code, or device. Proposed § 235.2(f)(2) further provides that "debit card" includes a "general-use prepaid card." *See* proposed comment 2(f)–4.

Proposed comment 2(f)–1 clarifies that the requirements of this part generally apply to any card, or other payment code or device, even if it is not issued in card form. That is, the rule applies even if a physical card is not issued or if the device is issued with a form factor other than a standard-sized card. For example, an account number or code that could be used to access underlying funds in an account would be considered a debit card under the rule (except when used to initiate an ACH transaction). Similarly, the term "debit card" would include a device with a chip or other embedded mechanism that links the device to funds held in an account, such as a mobile phone or sticker containing a contactless chip that enables the cardholder to debit an account.

Proposed comments 2(f)–2 and –3 address deferred and decoupled debit cards, two types of card products that the Board believes fall within the statutory definition of "debit card" notwithstanding that they may share both credit and debit card-like attributes. Under a deferred debit arrangement, transactions are not immediately posted to a cardholder's account when the card transaction is received by the account-holding institution for settlement, but instead the funds in the account are held and made unavailable for other transactions for a specified period of time.[34] Upon expiration of the time period, the cardholder's account is debited for the amount of all transactions made using the card which were submitted for settlement during that period. For example, under some deferred debit arrangements involving consumer brokerage accounts (whether held at the issuer or an affiliate), the issuer agrees not to post the card transactions to the brokerage account until the end of the month. Regardless of the time period chosen by the issuer for deferring the posting of the transactions to the cardholder's account, deferred debit cards would be considered debit cards for purposes of the requirements of this part. Deferred debit card arrangements do not refer to arrangements in which a merchant defers presentment of multiple small dollar card payments, but aggregates those payments into a single transaction for presentment, or where a merchant requests placement of a hold on certain funds in an account until the actual amount of the cardholder's transaction is known. *See* proposed comment 2(f)–2.

Proposed comment 2(f)–3 addresses decoupled debit arrangements in which the issuer is not the institution that holds the underlying account that will be debited. That is, the issuer-cardholder relationship is "decoupled" from the cardholder's relationship with the institution holding the cardholder's account. In these "decoupled debit" arrangements, transactions are not posted directly to the cardholder's account when the transaction is presented for settlement with the card issuer. Instead, the issuer must send an ACH debit instruction to the account-holding institution in the amount of the transaction in order to obtain the funds from the cardholder's account. As noted above, the term "debit card" includes a card, or other payment code or device, that debits an account, regardless of whether the issuer holds the account. Accordingly, the Board believes it is appropriate to treat decoupled debit cards as debit cards subject to the requirements of this part.

Moreover, the Board understands that there may be incentives for some issuers to design or offer products with "credit-like" features in an effort to have such products fall outside the scope of the interchange fee restrictions to be implemented by this rulemaking. For example, an issuer may offer a product that would allow the cardholder the option at the time of the transaction to choose when the cardholder's account will be debited for the transaction. Any attempt to classify such a product as a credit card is limited by the prohibition against compulsory use under the EFTA and Regulation E. Specifically, the EFTA and Regulation E provide that no person may condition the extension of credit to a consumer on such consumer's repayment by means of preauthorized electronic fund transfers.[35] Thus, an issuer of a charge or credit card is prohibited from *requiring* a consumer's repayment by preauthorized electronic fund transfers from a deposit account held by the consumer as a condition of opening the charge or credit card account. The Board solicits comment on whether additional guidance is necessary to clarify that deferred and decoupled debit, or any similar products, qualify as debit cards for purposes of this rule.

The proposed rule also sets forth certain exclusions from the term "debit card" in § 235.2(f)(3) to clarify the definition. Proposed § 235.2(f)(3)(i) clarifies that retail gift cards that can be used only at a single merchant or affiliated group of merchants are not subject to the requirements of this part. The Board believes that by including an explicit reference to general-use prepaid cards in the statutory definition of "debit card," Congress did not intend the interchange fee restrictions to apply to other types of prepaid cards that are accepted only at a single merchant or an affiliated group of merchants. These cards are generally used in a closed environment at a limited number of locations and are not issued for general use. *See* § 235.7(a), discussed below.

Proposed comment 2(f)–5 clarifies that two or more merchants are affiliated if they are related by either common ownership or common corporate control. For purposes of the definition of "debit card," the Board views franchisees 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. Accordingly, gift

[33] *See* EFTA Section 915(a)(2)(A).

[34] The issuer's ability to maintain the hold assumes that the issuer has received a settlement record for the transaction within the time period required under card network rules.

[35] EFTA Section 913(1); 12 CFR 205.10(e)(1).

cards that are redeemable solely at franchise locations would be excluded from the definition of debit card for cards, or other payment codes or devices, usable only at a single merchant or affiliated group of merchants, from the definition of "debit card."

Proposed § 235.2(f)(3)(ii) expands the statutory exclusion for paper checks to exempt any "check, draft, or similar paper instrument, or electronic representation thereof" from the definition of "debit card." This adjustment is proposed because in many cases paper checks may be imaged and submitted electronically for presentment to the paying bank. Proposed comment 2(f)–6 further clarifies that a check that is provided as a source of information to initiate an ACH debit transfer in an electronic check conversion transaction is not a debit card.

Finally, proposed § 235.2(f)(iii) would generally exclude ACH transactions from the requirements of this part. Specifically, the proposed exclusion provides that an account number is not a debit card when used to initiate an ACH transaction from a person's account. The Board believes that this exclusion is necessary to clarify that ACH transactions initiated by a person's provision of a checking account number are not "electronic debit transactions" for purposes of the network exclusivity and routing provisions under § 235.7. However, this exclusion is not intended to cover a card, or other payment code or device, that is used to directly or indirectly initiate an ACH debit from a cardholder's account, for example, under a decoupled debit arrangement.[36] Proposed comment 2(f)–7 sets forth this guidance.

General-Use Prepaid Cards (§ 235.2(i))

The statutory definition of "debit card" includes a "general-use prepaid card" as that term is defined under EFTA Section 915(a)(2)(A).[37] Proposed § 235.2(i) defines "general-use prepaid card" as 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 of "general-use prepaid card" generally tracks the definition as it appears under EFTA Section 915(a)(2)(A), with modifications to simplify and clarify the definition.[38] For example, the proposed rule refers to cards issued in a "specified" amount to capture a card, or other payment code or device, whether it is issued in a predenominated amount or in an amount requested by a cardholder in a particular transaction.

The inclusion of general-use prepaid cards in the definition of "debit card" under EFTA Section 920(c)(2)(B) refers only to the term "general-use prepaid card" as it is defined in EFTA Section 915(a)(d)(A), and does not incorporate the separate exclusions to that term that are set forth in the gift card provisions of the Credit Card Act.[39] Thus, for purposes of this proposed rule, the definition of "general-use prepaid card" would include the cards, or other payment codes or devices, listed under EFTA Section 915(a)(2)(D) to the extent they otherwise meet the definition of "general-use prepaid card."[40]

Proposed comment 2(i)–1 clarifies that a card, or other payment code or device, is "redeemable upon presentation at multiple, unaffiliated merchants" if, for example, the merchants agree, pursuant to the rules of the payment network, to honor the card, or other payment code or device, if it bears the mark, logo, or brand of a payment network. (*See,* however, proposed comment 2(f)–5, discussed above, clarifying that franchises subject to a common set of corporate policies or practices are considered to be affiliated.)

Proposed comment 2(i)–2 provides that a mall gift card, which is generally intended to be used or redeemed at participating retailers located within the same shopping mall or in some cases, within the same shopping district, would be considered a general-use prepaid card if it is also network-branded, which would permit the card to be used at any retailer that accepts that card brand, including retailers located outside the mall.

In some cases, a group of unaffiliated merchants may jointly offer a prepaid card that is only redeemable at the participating merchants. For example, "selective authorization" cards may be offered to encourage sales within a shopping mall or district or at merchants located in the same resort. Selective authorization cards generally are issued by a financial institution or member of a card network, rather than a program sponsor as in the case of many retail gift card programs. Transactions made using such cards are authorized and settled over the payment card networks just like other general-use prepaid cards. In addition, interchange transaction fees may be charged in connection with these cards because they are processed over a payment card network.

Selective authorization programs enable a merchant to offer gift cards to its customers and ensure that card funds are spent only within the participating merchant(s) without incurring the costs of setting up a separate program. There may be little difference between these programs and closed-loop retail gift card programs operated by a single retailer, but for the fact that these cards are accepted at merchants that are unaffiliated. However, requiring these selective authorization cards to comply with the network exclusivity and routing restrictions could be problematic and costly for the participating merchants with little corresponding benefit. Accordingly, comment is requested on whether a prepaid card that is accepted at a limited number of unaffiliated participating merchants and *does not* carry a network brand should also be considered a "general-use prepaid card" under the rule.

G. Sec. 235.2(g) Designated automated teller machine network (Designated ATM network)

EFTA Section 920(a)(7)(C) defines a "designated automated teller machine network" as 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. Proposed § 235.2(g) implements this definition substantially as set forth in the statute.

The Board is also proposing to clarify the meaning of "reasonable and convenient access," as that term is used in § 235.2(g)(2). Proposed comment 2(g)–1 provides that an issuer provides reasonable and convenient access, for example, if, for each person to whom a card is issued, the issuer provides access to an 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,

[36] However, a decoupled debit card issued by a merchant that can be used only at that merchant or its affiliate(s) may qualify for the separate exclusion under proposed § 235.2(f)(3)(i).

[37] *See* EFTA Section 920(c)(2)(B).

[38] *See also* 12 CFR 205.20(a)(3).

[39] For example, under the gift card provisions of the Credit Card Act, general-use prepaid cards do not include cards that are not marketed to the general public or cards issued in paper form only. *See* EFTA Section 915(a)(2)(D)(iv) and (v).

[40] The Board further notes that had Congress intended to apply the exclusions in EFTA Section 915(a)(2)(D) to the definition of "general-use prepaid card" for purposes of this rule, it would have been unnecessary to separately create an exemption for certain reloadable prepaid cards that are not marketed or labeled as a gift card. *See* EFTA Section 920(a)(7)(ii).

where the card was first purchased or issued, in order to access an ATM in the network. The purpose of this comment is to clarify that if an issuer does not have its own network of proprietary ATMs, as provided in § 235.2(g)(1), that the network the issuer identifies as its designated ATM network is one in which a person using a debit card can access an ATM with relative ease. The Board believes that having to travel a substantial distance from where the person is located, as determined by the last known address of the person to whom the card is issued, for an ATM in the network is neither reasonable nor convenient. The MSA is a common, well-known way of defining a community.[41] Therefore, the Board is proposing the MSA as a proxy for a reasonable distance from the person's location.

Furthermore, because a debit card includes a general-use prepaid card, for which the issuer may not have the address of the person using the card, the proposed comment provides that the issuer may use the location of where the card was first purchased or issued. The issuer of a general-use prepaid card may not have address information because either the person to whom the card is issued is not the ultimate user of the card, such as in the case of a gift card, or the issuer does not collect address information for the product. In these instances, the only location known to the issuer is the place where the card was first purchased or issued, and the issuer may assume that the person using the card is located in that same area. The Board also requests comment on whether additional clarification or guidance is needed for how an issuer may identify a network of automated teller machines that provides reasonable and convenient access to the issuer's cardholders.

H. Sec. 235.2(h) Electronic debit transaction

EFAT section 920(c)(5) defines the term "electronic debit transaction" as "a transaction in which a person uses a debit card." The Board's proposed definition in § 235.2(h) adds two clarifying provisions.

First, proposed § 235.2(h) clarifies that the term "electronic debit transaction" is a transaction in which a person uses a debit card as "a form of payment." The statute defines payment card network, in part, as a network a person uses to accept a debit card as a form of payment. For clarity, the Board proposes to incorporate that requirement into the definition of electronic debit transaction.

Second, the statutory definition is silent as to whether use of the debit card must occur within the United States. Proposed § 235.2(h) limits electronic debit transactions to those transactions where a person uses a debit card for payment in the United States. The Board found no indication in the statute that Congress meant to apply the interchange provisions extraterritorially. Moreover, if a person uses a debit card outside the United States, even if such use is to debit an account located in the United States, the amount of the interchange transaction fees the issuer may receive often is determined by the network rules for cross-border transactions or the laws or regulations of the country in which the merchant is located. Therefore, electronic debit transactions subject to the proposed rule are those that occur at a merchant located within the United States.

Proposed comment 2(h)–1 explains that the term "electronic debit transaction" includes transactions in which a person uses a debit card other than for the initial purchase of goods or services. For example, after purchasing goods or services, a person may decide that such goods and services are unwanted or defective. If permitted by agreement with the merchant, that person may return the goods or cancel the services and receive a credit using the same debit card used to make the original purchase. Proposed § 235.2(h) covers such transactions. The Board understands, however, that issuers typically do not receive interchange fees for these transactions. Proposed comment 2(h)–2 clarifies that transactions in which a person uses a debit card to purchase goods or services and also receives cash back from the merchant are electronic debit transactions.

I. Sec. 235.2(j) Interchange transaction fee

Proposed § 235.2(j) generally incorporates the EFTA Section 920(c)(8)'s definition of "interchange transaction fee" that defines the term 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." A payment card network may determine interchange transaction fees according to a schedule that is widely applicable, but also may permit bilateral negotiation of fees between issuers and acquirers or merchants, as well as specialized interchange transaction fee arrangements.

As discussed above, interchange transaction fees today are used to reimburse issuers for their involvement in electronic debit transactions by transferring value between acquirers and issuers. In general, payment card networks establish the interchange transaction fees, although the issuers are receiving the fees by reducing the amount remitted for a particular transaction by the amount of that transaction's interchange transaction fee. Therefore, the merchants or acquirers are paying the amount of the interchange transaction fee. The proposed definition, however, clarifies that interchange transaction fees are paid by merchants or acquirers. *See* proposed comment 2(j)–1.

Proposed comment 2(j)–2 restates the rule that interchange fees are limited to those fees established, charged or received by a payment card network for the purpose of compensating the issuer, and not for other purposes, such as to compensate the network for its services to acquirers or issuers.

J. Sec. 235.2(k) Issuer

Proposed § 235.2(k) incorporates the statute's definition of "issuer" that defines the term as "any person who issues a debit card or the agent of such person with respect to the card." Proposed § 235.2(k) follows the statutory definition, but removes the phrase "or the agent of such person with respect to the card." Because agents are, as a matter of law, held to the same restrictions with respect to the agency relationship as their principals, the Board does not believe that removing this clause will have a substantive effect.

Issuing a debit card is the process of providing a debit card to a cardholder. The issuing process generally includes establishing a direct contractual relationship with the cardholder with respect to the card and providing the card directly or indirectly to the cardholder. The debit card provided may or may not have the issuer's name on the card. For example, a prepaid card may be issued by a bank that has partnered with another entity (*e.g.,* a retail store) and the other entity's name may be on the prepaid card. Further, as discussed below, the issuer is not necessarily the institution that holds the cardholder's account that will be debited.

Similar to merchant-acquirer relationships, the issuer-cardholder relationship varies. Proposed comments 2(k)–2 through 2(k)–5 clarify which entity is the issuer in the most prevalent issuing arrangements. In the simple four-party system, the financial

[41] *See* U.S. Census Bureau for information on MSAs, available at *http://www.census.gov/population/www/metroareas/metroarea.html.*

institution that holds the account is the issuer because that is the institution that directly or indirectly provides the debit card to the cardholder, holds the cardholder's account and has the direct contractual relationship with the cardholder with respect to the card. If the debit card is a prepaid card, the cardholder may receive the card from a merchant or other person, and thus may not receive the card directly from the issuing bank, which is the entity that holds the account that pools together the funds for many prepaid cards. *See* proposed comment 2(k)–2.

In contrast, in a three-party system, the network typically provides the debit card or prepaid card directly to the cardholder or through an agent. Generally, the network also has a direct contractual relationship with the cardholder. Notwithstanding the other roles the network may have with respect to the transaction, the network is considered an issuer under proposed § 235.2(k) because it provides the card to the cardholder, and may also be the account-holding institution. *See* proposed comment 2(k)–3.

A variation of the issuer relationship within the four-party and three-party systems involves the licensing or assignment of Bank Identification Numbers (BINs), which are numbers assigned to financial institutions by the payment card networks for purposes of issuing cards. Some members of payment card networks permit other entities that are not members to issue debit cards using the member's BIN. The entity permitting such use is referred to as the "BIN sponsor." The entity using the BIN sponsor's BIN ("affiliate member") typically holds the account of the cardholder and directly or indirectly provides the cardholder with the debit card. The cardholder's direct relationship is with the affiliate member. Proposed comment 2(k)–4.i and .ii describes two circumstances involving BIN sponsorship arrangements and provides guidance on the entity that would be considered to be the issuer in those circumstances.

Another variant of the issuer relationship within the four-party and three-party systems is the decoupled debit card arrangement. In a decoupled debit card arrangement, a third-party service provider (which may or may not be a financial institution) issues a debit card to the cardholder and enters into a contractual relationship with the cardholder with respect to the decoupled debit card. Therefore, proposed comment 2(k)–5 clarifies that the entity directly or indirectly providing the cardholder with the card is considered the issuer under proposed § 235.2(k).

Some issuers outsource to a third party some of the functions associated with issuing cards and authorizing, clearing, and settling debit card transactions. A third party that performs certain card-issuance functions on behalf of an issuer would be subject to the same restrictions as the issuer in the performance of those functions. An issuer that outsources certain issuing functions retains the underlying relationship with the cardholder and should retain responsibility for complying with the rule's requirements as they pertain to issuers. Therefore, the Board's proposed definition of "issuer" does not include the phrase "or agent of the issuer with respect to such card." The Board requests comment on whether there are circumstances in which an agent of an issuer also should be considered to be an issuer within the rule's definition.

Proposed § 235.2(k)'s definition of "issuer" applies throughout this part, except for the provisions exempting small issuers.[42] For purposes of that exemption, EFTA Section 920 limits the term "issuer" to the person holding the account that is debited through the electronic debit transaction. For example, issuers of decoupled debit cards are not considered issuers for purposes of the small issuer exemption because they do not hold the account being debited.

The Board requests comment on all aspects of the issuer definition. The Board specifically requests comment on whether the appropriate entity is deemed to be the issuer in relation to the proposed examples.

L. Sec. 235.2(l) Merchant

The statute does not define the term "merchant." The term is used throughout the proposed rule, and the Board is proposing to define a merchant as a person that accepts a debit card as payment for goods or services.

M. Sec. 235.2(m) Payment card network

EFTA Section 920(c)(11) defines the term "payment card network" as (1) 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 (2) that a person uses in order to accept as a form of payment a brand of debit card, credit card, or other device that may be used to carry out debit or credit transactions. Proposed § 235.2(m) follows this definition, with revisions for clarity.

Under the proposed rule, a payment card network is generally defined as an "entity that directly or indirectly provides the proprietary services, infrastructure, and software for authorization, clearance, and settlement of electronic debit transactions." Because the interchange fee restrictions and network exclusivity and merchant routing provisions of the Dodd-Frank Act do not apply to credit card transactions, the Board believes it is appropriate to exclude from the proposed definition the reference to credit cards in the statutory definition to avoid unnecessary confusion. No substantive change is intended. Likewise, the Board does not believe its necessary to state that a payment card network is an entity that a person uses in order to accept debit cards as a form of payment, because proposed § 235.2(h) defines the term "electronic debit transaction," as use of a debit card "as a form of payment."

In addition, the term "payment card network," as defined in EFTA Section 920, could be interpreted broadly to include *any* entity that is involved in processing an electronic debit transaction, including the acquirer, third-party processor, payment gateway, or software vendor that programs the electronic terminal to accept and route debit card transactions. Each of these entities arguably provide "services, infrastructure, and software" that are necessary for authorizing, clearing, and settling electronic debit transactions. However, the Board does not believe that this is the best interpretation in light of the statute's objectives. Instead, the Board believes that the better interpretation is that in general, the term "payment card network" only applies to an entity that establishes the rules, standards, or guidelines that govern the rights and responsibilities of issuers and acquirers involved in processing debit card transactions through the payment system. Accordingly, proposed § 235.2(m)(2) makes this clarification. The rules, standards, or guidelines may also govern the rights and responsibilities of participants other than issuers and acquirers. *See* proposed comment 2(m)–1.

In certain cases, such as in a three-party system, the same entity may serve multiple roles, including that of the payment card network, the issuer, and the acquirer. Proposed comment 2(m)–1 clarifies that the term "payment card network" would also cover such entities to the extent that their rules, standards,

[42] *See* discussion of proposed § 235.5(a) in the section-by-section analysis.

or guidelines also cover their activities in their role(s) of issuer and/or acquirer. Proposed comment 2(m)–1 further clarifies that the term "payment card network" would generally exclude acquirers, issuers, third-party processors, payment gateways, or other entities that may provide services, equipment, or software that may be used in authorizing, clearing, or settling electronic debit transactions, unless such entities also establish guidelines, rules, or procedures that govern the rights and obligations of issuers and acquirers involved in processing an electronic debit transactions through the network. For example, an acquirer is not considered to be a payment card network due to the fact that it establishes particular transaction format standards, rules, or guidelines that apply to electronic debit transactions submitted by a merchant that uses the acquirer's services, because such standards, rules, or guidelines would apply only to the merchant using the acquirer's services, and not to other entities that may also be involved in processing those transactions, such as the card issuer.

The Board requests comment on whether other non-traditional or emerging payment systems would be covered by the statutory definition of "payment card network." For example, consumers may use their mobile phone to send payments to third parties to purchase goods or services with the payment amount billed to their mobile phone account or debited directly from the consumer's bank account. In addition, consumers may use a third party payment intermediary, such as PayPal, to pay for Internet purchases, using the consumer's funds that may be held by the intermediary or in the consumer's account held at a different financial institution. In both examples, the system or network used to send the payment arguably provide the "proprietary services, infrastructure, and software for authorization, clearance, and settlement of electronic debit transactions." Transactions involving these methods of payment typically are subject to rules and procedures established by the payment system. If such systems are not covered, the Board requests specific comment how it should appropriately distinguish these payment systems from traditional debit card payment systems that are subject to the rule.

N. Sec. 235.2(n) Person

The term "person" is not defined in the EFTA. The proposed definition incorporates the definition of the term in existing Board regulations.[43]

O. Sec. 235.2(o) Processor

EFTA Section 920 uses the term "processor" but does not define the term. Proposed § 235.2(o) defines the term "processor" as a person that processes or routes electronic debit transactions for issuers, acquirers, or merchants.

P. Sec. 235.2(p) United States

Proposed § 235.2(p) defines the term "United States." The proposed definition is modified from the EFTA's definition of "State." (15 U.S.C. 1693a(10)).

III. Sec. 235.3 Reasonable and proportional interchange transaction fees

Proposed § 235.3 sets forth 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.

A. Statutory Considerations

1. Reasonable and Proportional to Cost

As noted above, EFTA Section 920 requires the Board to establish standards for assessing whether the amount of any interchange transaction fee 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. EFTA Section 920 does not define "reasonable" or "proportional." The Board has found only limited examples of other statutory uses of the terms "reasonable" or "proportional" with respect to fees.[44] One example is Section 149 of the Truth in Lending Act (TILA), which limits credit card penalty fees for violations of the cardholder agreement to fees that are reasonable and proportional to the violation. In implementing standards under TILA Section 149, the Board relied on the commonly accepted legal definition of "reasonable" ("fair, proper, or moderate") and the commonly accepted definition of "proportional" ("corresponding in degree, size, or intensity" or "having the same or constant ratio").[45]

Although the Board believes the previously relied upon definitions can inform this rulemaking, the Board notes that reasonableness and proportionality have different connotations in the context of interchange transaction fees than in the context of penalty fees. The TILA provision related to the reasonableness and proportionality of the fees charged when a violation of the account terms occurred. TILA required the Board to consider the costs incurred by issuers as a result of violations and other factors, including the need to deter violations. In considering whether an interchange fee is reasonable, the Board proposes to consider whether the fee is fair or proper in relation to both the individual issuer's costs as well as the costs incurred by other issuers. As discussed further below, the Board believes it may determine that certain fee levels are reasonable based on overall issuer cost experience, even if the individual issuer's costs are above (or below) that fee level.

Similarly, in considering whether an interchange fee is proportional to the issuer's costs, the Board does not believe that proportionality must be interpreted to require identical cost-to-fee ratios for all covered issuers (although a constant cost-to-fee ratio would result from the issuer-specific standard discussed below for issuers with allowable costs below the cap). Rather, if the Board were to adopt a safe harbor or a fee cap (discussed further below) that it determined to be reasonable, the cost-to-fee ratio of any issuer that received fees at or below the safe harbor or cap would be deemed to meet the proportionality standard.

2. Considerations for Standards

In EFTA Section 920, Congress set forth certain factors that the Board is required to consider when establishing standards for determining whether interchange transaction fees are reasonable and proportional to the cost

[43] Regulation Z (Truth in Lending Act), 12 CFR 226.2(a)(22); Regulation CC (Availability of Funds and Collections of Checks), 12 CFR 229.2(yy);

[44] Several public utility rate-setting statutes require "just and reasonable" rates. *See, e.g.,* Natural Gas Act, 15 U.S.C. 717 *et seq.* In the public utility rate-setting context, a "just and reasonable" rate requires that the public utility be able "to operate successfully, to maintain financial integrity, to attract capital, and to compensate its investors for the risk assumed." *Duquense Light Co.* v. *Barash,* 488 U.S. 299 (1989). The Board believes that the similarities between these statutes and Section 920, however, are limited. Public utility rate-setting involves unique circumstances, none of which are present in the case of setting standards for interchange transaction fees. Issuers are unlike public utilities, which, in general, are required to make their services regularly available to the public. In addition, unlike in the case of public utilities where the utility's only source of revenue is the fees charged for the service or commodity, issuers have other sources, besides interchange fees, from which they can receive revenue to cover their costs of operations and earn a profit.

[45] *See* 75 FR 37526, 37531–32 (June 29, 2010), *Black's Law Dictionary* at 1272 (7th ed. 1999)(defining "reasonable") and *Merriam Webster's Collegiate Dictionary* at 936 (10th ed. 1995) (defining "proportional").

incurred by the issuer. Specifically, EFTA Section 920 requires the Board to (1) consider the functional similarity between electronic debit transactions and checks, which are required to clear at par through the Federal Reserve System and (2) distinguish between the incremental cost of authorization, clearance, and settlement of a particular transaction, which shall be considered, and other costs that are not specific to a particular transaction, which shall not be considered. Although Section 920 requires only the *consideration* of these factors, the Board believes that they are indicative of Congressional intent with respect to the implementation of Section 920, and therefore provide a useful measure for which costs should and should not be included in "the cost incurred * * * with respect to the transaction."

Similarities to Check

There are a number of similarities between the debit card and check payment systems. Both are payment instruments that result in a debit to the payor's asset account. Debit card payments are processed electronically, and while historically check processing has been paper-based, today virtually all checks are processed and collected electronically. Further, depository institutions have begun to offer their depositors remote deposit capture services to enable merchants to deposit their checks electronically. For both debit card and check payments, merchants pay fees to banks, processors, or intermediaries to process the payments. Settlement time frames are roughly similar for both payment types, with payments settling within one or two days of deposit.

However, there are also differences between debit card and check payment systems.

Open versus closed systems. Debit card networks are closed systems that both issuing and acquiring banks must join in order to accept and make payments. To accept debit card payments, issuing and acquiring banks must decide which debit card networks to join, establish a relationship with those networks, and agree to abide by those networks' rules. In contrast, the check system is an open system in which 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 merchant's bank need not join a network in order to collect a check.

Payment authorization. Payment authorization is an integral part of the processing of a transaction on a debit card network. As part of the payment authorization process, a card issuer determines, among other things, whether the card is valid and whether there are sufficient funds to cover the payment. In contrast, payment authorization is not an inherent part of the check acceptance process, and therefore a merchant does not know whether the check will be returned unpaid at the time the merchant accepts the check. However, a merchant that wants to better manage its risks associated with unpaid checks can purchase value-added check verification and guarantee services from various third-party service providers.

Processing and collection costs. In the check system, the payee's bank (which is analogous to the merchant-acquiring bank for debit cards) either incurs costs to present a check directly to the payor's bank (which is analogous to the card-issuing bank) or pays fees to intermediaries to collect and present the check to the payor's bank. In either case, the payor's bank does not incur fees to receive check presentments unless it has agreed to pay a fee to receive its presentments electronically. In debit card systems, the merchant-acquiring and card-issuing banks both pay fees to the network to process payments for their respective customers.

Par clearing. In the check system, payments clear at par. When a payee's bank presents a check to the payor's bank, the payor's bank pays and the payee's bank receives the face value of the check. As discussed above, a payee's bank may pay fees to an intermediary for check collection services; however, check payments are cleared and settled for the full face value of the checks. The payee's bank is not required to pay a fee to the payor's bank to receive the settlement for the full value of the checks presented. In contrast, in the debit card system, because interchange fees represent fees paid by the merchant-acquiring bank to card-issuing banks, the merchant-acquiring bank receives less than the full value of debit card payments.

Routing. In the check system, the payee's bank decides the avenue through which it collects checks. Checks can be presented directly to the payor's bank, collected through an intermediary for a fee, or exchanged through a clearing house.[46] The decision is often based on the avenue that offers the lowest clearing cost. For a debit card payment, the merchant's choice with regard to routing is limited to the set of networks whose cards the merchant accepts and that are also available to process a transaction for its customer's card. Merchant payment routing may be further limited if the card issuer has designated routing preferences that must be honored when a customer presents a card that can be used for payment on multiple (typically PIN) networks. Such preferences may result in a transaction being routed to a network that imposes a higher fee on the merchant's bank (and hence the merchant) than if the payment were processed on another available network.

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, a check must be returned by the "midnight deadline," which is midnight of the banking day after the check was presented to the payor's bank for payment. After the midnight deadline passes, a payor's bank can no longer return the payment through the check payment system, although it may have legal remedies in the event of a dispute or financial loss.[47] In contrast, in the debit card system, the time period within which a transaction may be reversed is not as limited. Typically, many disputes can be addressed through network chargeback processes without having to rely on legal remedies. These chargebacks and disputes can be handled through the network with procedures that are delineated in network rules.

Activity Costs To Be Considered

As noted above, the statute provides that, in establishing standards for assessing whether an interchange fee is reasonable and proportional to "the cost incurred by the issuer with respect to the transaction," the Board shall consider the incremental cost of authorizing, clearing, and settling a particular transaction and shall not consider other costs that are not specific to a particular transaction.[48] The statute is silent with respect to costs that are specific to a particular transaction other than incremental costs incurred by an issuer for authorizing, clearing, and settling the transaction.

After considering several options for the costs that may be taken into account in setting interchange transaction fees ("allowable costs"), the Board proposes such costs be limited to those associated with authorization, clearing, and settlement of a transaction. This formulation includes only those costs

[46] For checks exchanged through a clearing house, both the payor's bank and the payee's bank must be members of or participate in the clearing house.

[47] Uniform Commercial Code 4–301 and 4–302.

[48] Sec. 920(a)(3).

that are specifically mentioned for consideration in the statute. If an issuer outsources its authorization, clearance, and settlement activities, allowable costs would include fees paid to a processor for authorization, clearance, and settlement services.

In the definition of allowable costs, the Board proposes to exclude network processing fees (*i.e.,* switch fees) paid by issuers.[49] Card issuers pay such fees to payment card networks for each transaction processed over those networks. Although these network fees typically are not associated with one specific component of authorization, clearance, or settlement of the transaction, a particular transaction cannot be authorized, cleared, and settled through a network unless the issuer pays its network processing fees. The Board proposes that network processing fees be excluded from allowable costs, because the Board recognizes that if network processing fees were included in allowable costs, acquirers (and, by extension, merchants) might be in the position of effectively paying all network fees associated with debit card transactions. That is, an acquirer would pay its own network processing fees directly to the network and would indirectly pay the issuer's network processing fees through the allowable costs included in the interchange fee standard.[50]

The Board considered including other costs associated with a particular transaction that are not incurred by the issuer for its role in authorization, clearing, and settlement of that transaction. Such costs might include, for example, cardholder rewards that are paid by the issuer to the cardholder for each transaction. The Board does not view the costs of cardholder rewards programs as appropriate for consideration within the context of the statute. Other costs associated with a particular debit transaction might also include costs associated with providing customer service to cardholders for particular transactions, such as dealing with cardholder inquiries and complaints about a transaction. Given the statute's mandate to consider the functional similarities between debit transactions and check transactions, the Board proposes that allowable costs be limited to those that the statute specifically allows to be considered, and not be expanded to include additional costs that a payor's bank in a check transaction would not recoup through fees from the payee's bank.

The Board requests comment on whether it should allow recovery through interchange fees of other costs of a particular transaction beyond authorization, clearing, and settlement costs. If so, the Board requests comment on what other costs of a particular transaction, including network fees paid by issuers for the processing of transactions, should be considered allowable costs. The Board also requests comment on any criteria that should be used to determine which other costs of a particular transaction should be allowable.

The Board considered limiting the allowable costs to include only those costs associated with the process of authorizing a debit card transaction, because this option may be viewed as consistent with a comparison of the functional similarity of electronic debit transactions and check transactions. Among the most prominent differences between debit cards and checks is the existence of authorization for a debit card transaction where the deposit account balance is checked at the time of the transaction to ensure that the account has sufficient funds to cover the transaction amount. Clearing and settlement occur for both debit cards and checks, but for checks there is nothing analogous to an interchange fee to reimburse the issuer for the cost of clearing and settling a transaction. However, because the statute instructs the Board to also consider the costs of clearance and settlement, the Board proposes to include those costs. The Board requests comment on whether it should limit allowable costs to include only the costs of authorizing a debit card transaction.

Cost Measurement

As noted above, the statute specifically requires consideration of the "incremental" cost of authorization, clearance, and settlement of a particular transaction. There is no single, generally-accepted definition of the term "incremental cost." One commonly-used economic definition of "incremental cost" refers to the difference between the cost incurred by a firm if it produces a particular quantity of a good and the cost incurred by that firm if it does not produce the good at all.[51] Other definitions of incremental cost consider the cost of producing some increment of output greater than a single unit but less than the entire production run. However, under any of these definitions, the increment of production is larger than the cost of any particular transaction (and, in the first definition, as large as the entire production run in the first case).[52] As a result, the Board believes that these definitions of incremental cost do not appropriately reflect the incremental cost of a particular transaction to which the statute refers.

The Board proposes that the interchange fee standard allow for the inclusion of the per-transaction value of costs that vary with the number of transactions (*i.e.*, average variable cost) within the reporting period. This cost calculation yields the cost of a typical or average transaction. This measure of per-transaction cost does not consider costs that are shared with other products of an issuer, such as common fixed or overhead costs, which would still be incurred in the absence of debit card transactions. For example, the Board does not believe that other costs of deposit accounts or, more generally, depository institutions, which cannot be attributable to debit card transactions, are appropriate to include in allowable costs. While a debit card program may not exist if certain costs are not incurred, such as account set-up costs or corporate overhead costs, it does not follow that those costs would be avoided in the absence of a debit card program.

However, if variable costs of authorizing, clearing, and settling debit card transactions are shared with credit card operations, the Board believes that some portion of such costs should be allocated to debit card transactions. For example, these costs may be recorded jointly in internal cost accounting systems or not separated on third-party processing invoices. These costs should be allocated to debit cards based on the proportion of debit card transactions to total card transactions.

[49] These fees do not include processing fees paid by an issuer to a network in its role as processor (*i.e.,* a role equivalent to that of an issuer's third-party processor).

[50] Such an arrangement would be similar to traditional paper-check processing where the payee's bank typically pays all of the processing costs, while the payor's bank typically pays no processing fees. However, this arrangement would be consistent with electronic check collection systems where both the payor's bank and payee's bank generally pay processing fees.

[51] Baumol, William J., John C. Panzar, and Robert D. Willig (1982), *Contestable Markets and the Theory of Industry Structure.* New York: Harcourt Brace Jovanovich. This definition involves 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. Notably, this measurement excludes any common costs across goods that a firm produces, such as common fixed overhead costs, as those costs would still be incurred if production of the good of interest were ceased.

[52] Fundamentally, none of these definitions correspond to a per-transaction measure of incremental cost that could be applied to any particular transaction, regardless of the particular transaction used for such a definition.

This measure would *not* consider costs that are common to all debit card transactions and could never be attributed to any *particular* transaction (*i.e.*, fixed costs), even if those costs are specific to debit card transactions as a whole. Such fixed costs of production could not be avoided by ceasing production of any particular transaction (except perhaps the first).

The Board recognizes that, by distinguishing variable costs from fixed costs, this standard imposes a burden on issuers by requiring issuers to segregate costs that vary with the number of transactions from those that are largely invariant to the number of transactions, within the reporting period. The Board also acknowledges that differences in cost accounting systems across depository institutions may complicate enforcement by supervisors. Finally, the Board recognizes that excluding fixed costs may prevent issuers from recovering through interchange fees some costs associated with debit card transactions. However, as noted above, the Board also recognizes that issuers have other sources, besides interchange fees, from which they can receive revenue to help cover the costs of debit card operations. Moreover, such costs are not recovered from the payee's bank in the case of check transactions.

The Board also considered a cost measurement in terms of marginal cost or, in other words, the cost of an additional transaction. However, marginal cost can be different for each unit of output, and it is unclear which unit of output's cost should be considered, although often it is assumed to be the last unit. Notably, if marginal cost does not vary materially over the relevant volume range, then average variable cost will provide a close approximation to marginal cost for any particular transaction.[53] In addition, average variable cost is more readily measurable than marginal cost for issuers and supervisors. Specifically, marginal cost for a given issuer cannot be calculated from cost accounting data; instead, it must be identified and estimated based on assumptions about costs that would have been incurred if an issuer's transaction volume had differed from that which actually occurred.[54]

The Board requests comment on whether it should include fixed costs in the cost measurement, or alternatively, whether costs should be limited to the marginal cost of a transaction. If the latter, the Board requests comment on how the marginal cost for that transaction should be measured.

B. Proposed Interchange Fee Standards

The statute requires that 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."[55] Proposed § 235.3 sets forth two alternatives (referred to as "Alternative 1" and "Alternative 2") for determining the level of the allowable interchange fee. Alternative 1 proposes an issuer-specific approach combined with a safe harbor and a cap. Under Alternative 1, an issuer may receive or charge interchange transaction fees at or below the safe harbor amount or based on a determination of its allowable costs, up to a cap. Alternative 2 proposes a stand-alone cap. The Board proposes to adopt only one of the alternatives and requests comment on each, as well as on any other alternatives that could be applied.

1. Alternative 1—Issuer-Specific up to a Cap, With a Safe Harbor

Under Alternative 1, an issuer could comply with the regulatory standard for interchange fees by calculating allowable per-transaction cost, based on the allowable costs described by the Board, and ensuring that it did not receive an interchange fee for any transaction in excess of its allowable per-transaction cost. Proposed § 235.3(c) sets forth an issuer's allowable costs. As discussed above, these are the issuer's costs that are attributable to its role in authorization, clearance, and settlement of electronic debit transactions and that vary, up to existing capacity limits within a reporting period, with the number of electronic debit transactions sent to the issuer. Network fees paid by the issuer are excluded from allowable costs. Proposed § 235.3(b)(2) limits the amount of any interchange fee that an issuer may receive to no more than the allowable costs divided by the number of electronic debit transactions on which the issuer received or charged an interchange transaction fee in the calendar year.

Alternative 1 also provides for a cap of 12 cents per transaction (proposed § 235.3(b)(2)). An issuer could not receive an interchange fee above the cap regardless of its allowable cost calculation. In addition, Alternative 1 would deem any interchange fee at or below a safe harbor level of 7 cents per transaction to be in compliance with the regulatory standard (proposed § 235.3(b)(1)), regardless of the issuer's allowable per-transaction cost.

Under Alternative 1, each payment card network could set interchange fees for each issuer (1) at or below the safe harbor[56] or (2) at a level for the issuer that would not exceed the issuer's allowable per-transaction costs up to the cap.[57] A network would be permitted to set fees that vary with the value of the transaction (*ad valorem* fees), as long as the maximum amount of the interchange fee received by an issuer for any electronic debit transaction was not more than that issuer's maximum permissible interchange fee. A network would also be permitted to establish different interchange fees for different types of transactions (*e.g.,* card-present and card-not-present) or types of merchants, as long as each of those fees satisfied the relevant limits of the standard. Each issuer's supervisor would verify that the amount of any interchange fee received by an issuer is, in fact, commensurate with the safe harbor, the issuer's allowable per-transaction costs, or the cap, as appropriate. Each of the three elements of this alternative, the issuer-specific determination, the cap, and the safe harbor, are discussed in more detail below.

Issuer-Specific Determination

EFTA Section 920(a)(2) requires that "the amount of any interchange transaction fee that an issuer may receive or charge * * * be reasonable and proportional to the cost incurred by the issuer with respect to the transaction." One reading of that provision is that the use of the definite article "the" in the second half of the standard suggests that the interchange fee limitation should be determined separately for each issuer and each transaction presented to that issuer. As discussed below, however, such an approach would be impractical and difficult to administer and enforce, and would introduce undesirable economic incentives.

Measuring the allowable cost of each transaction would be highly impracticable due to the volume of

[53] In particular, if marginal cost is constant, then average variable cost equals marginal cost. More generally, average variable cost equals the average marginal cost across all transactions.

[54] *See,* Turvey, Ralph "What are Marginal Costs and How to Estimate Them?" University of Bath School of Management, Centre for the Study of Regulated Industries, Technical Paper 13(2000).

[55] *See* Sec. 920(a)(2) of the EFTA.

[56] This rule would not require a payment card network to set an interchange fee above the safe harbor. Whether a network would implement an issuer-specific interchange fee is the network's prerogative.

[57] Under this option, if a network planned to establish interchange fees on a per-issuer basis above the safe harbor, an issuer would report its maximum allowable interchange fee to the network.

transactions and the fact that the cost of each transaction is likely not known when the interchange fee is charged. The Board believes that the average variable cost, as discussed above, provides a reasonable approximation of an issuer's per-transaction cost for its role in authorization, clearance, and settlement. The Board believes that a maximum interchange fee determined on an issuer-specific basis as provided in Alternative 1 is both reasonable, in that it reflects only those allowable costs identified by the Board (up to a cap, discussed further below), and is directly proportional to the issuer's actual costs.

From an economic perspective, an issuer-specific determination directly links the compensation through interchange fees for each issuer to that issuer's specific costs. A major drawback of this approach is that it would not provide incentives for issuers to control their costs. In particular, an issuer that is eligible to recoup its costs under an issuer-specific determination with no cap would face no penalty for having high costs. Conversely, because a reduction in costs would lead to a reduction in an issuer's interchange fee, an issuer would receive no reward for reducing its costs (in the absence of a safe harbor). As a result, issuers would have no incentive to minimize their costs and may incur higher costs than they would otherwise. An issuer-specific determination might also encourage over-reporting of costs by an issuer because any inflation of the reported costs would be directly rewarded with a higher interchange fee for the issuer. Such undesirable incentive properties have generally led economists to advocate the abandonment of cost-of-service regulation in regulated industries in favor of approaches that yield better incentives to the regulated entities.[58]

An issuer-specific determination, on its own, would also place a significant implementation and administration burden on industry participants and supervisors. Each issuer would have to account for its costs in a manner that enables it to segregate allowable costs that could be recovered through the interchange fee from its other costs, tabulate those costs on an ongoing basis, and report them to the networks in which it participates. A network that set issuer-specific fees would need to incorporate such fees into its fee schedules, including the operational ability to distinguish among many different issuers in order to apply different rates to each of those issuers' transactions. The issuers' supervisors would need to evaluate each issuer's reported costs and verify that each issuer's interchange fees appropriately reflect those reported costs.

Cap

To address, at least in part, the incentive problems discussed above with respect to a purely issuer-specific determination, the Board proposes to place a ceiling on the amount of any issuer-specific determination by specifying a cap of 12 cents per transaction. With an issuer-specific determination and a cap, the Board would deem any interchange fee that was equal to an issuer's allowable costs to be reasonable and proportional to the issuer's costs if it is at or below the cap.

Some issuers that are subject to the interchange fee limitations have debit card programs with substantially higher per-transaction costs than others. These unusually high costs might be due to small programs targeted at high-net-worth customers or newer start-up programs that have not yet achieved economies of scale. In comparing reported per-transaction costs to current interchange transaction fee levels, the Board believes it is unlikely that these issuers currently are recovering their per-transaction costs through interchange transaction fees. The Board does not believe it is reasonable for the interchange fee to compensate an issuer for very high per-transaction costs. The Board believes that setting the cap at 12 cents per transaction will be sufficient to allow all but the highest-cost issuers discussed above to recover through interchange transaction fees the costs incurred for authorizing, clearing, and settling electronic debit transactions. The Board notes that even the highest-cost issuers have sources of revenue in addition to interchange fees, such as cardholder fees, to help cover their costs.

A cap would eliminate some of the negative incentives of a purely issuer-specific determination. An issuer with costs above the cap would not receive interchange fees to cover those higher costs. As a result, a high-cost issuer would have an incentive to reduce its costs in order to avoid this penalty. The Board would re-examine the cap periodically (to coincide with the reporting requirements in proposed § 235.8) to ensure that the cap continues to reflect a reasonable fee.

To determine an appropriate value for a cap, the Board used data from responses to the card issuer survey described earlier. The Board used data on transaction volumes and the variable cost of authorization, clearing, and settlement (the allowable costs under an issuer-specific determination) to compute an issuer's per-transaction cost. These data were used to compute various summary measures of per-transaction variable costs for issuers, generally. For this sample of issuers, the Board estimated that the per-transaction variable costs, averaged across all issuers, were approximately 13 cents per transaction. Average per-transaction variable costs were approximately 4 cents per transaction when each issuer's costs are weighted by the number of its transactions.[59] The 50th percentile of estimated per-transaction variable costs was approximately 7 cents.

The Board proposes a cap of 12 cents per transaction because, while it significantly reduces interchange fees from current levels (approximately 44 cents per transaction, on average, based on the survey of payment card networks), it allows for the recovery of per-transaction variable costs for a large majority of covered issuers (approximately 80 percent). The proposed cap does not differentiate between different types of electronic debit transactions (*e.g.,* signature-based, PIN-based, or prepaid). From the survey results, the Board found some evidence of differences in allowable costs across signature and PIN debit transactions. In particular, the mean and median values of allowable costs for signature debit transactions were approximately 2 cents higher per transaction than the analogous figures for PIN debit transactions, while the 80th percentile was approximately 1 cent higher per transaction for signature debit transactions. However, because these estimates are based on a sample of data, and because the variation among the individual issuers' costs was large, the ability to reliably infer a statistically significant difference from the data is limited. As a result, the Board does not propose to distinguish initially between the cap value for signature and PIN debit transactions, for either Alternative 1 or Alternative 2. For the same reasons, as described below, the Board does not propose to allow the safe harbor value to vary initially by authorization method. The Board requests comment on whether it should allow for such differences in the cap or safe harbor values.

The Board notes that issuers reported higher costs for authorizing, clearing, and settling prepaid card transactions

[58] Joskow, Paul L. (2008), "Incentive Regulation and its Application to Electricity Networks," *Review of Network Economics,* Vol. 7, Issue 4, pp. 547–60. Kahn, Alfred E. (1988), *The Economics of Regulation: Principles and Institutions,* Cambridge: MIT Press.

[59] This value corresponds to the aggregate per-transaction cost for all covered issuers.

(many of which are likely to be exempt from the interchange fee restrictions). The Board believes that issuers reported higher prepaid costs for one or more of the following reasons. First, many prepaid programs use stand-alone components, such as processing infrastructure, that are unable to exploit economies of scale that result from a large number of prepaid transactions or other debit card transactions. Second, because of the stand-alone components, all costs are allocated to prepaid card programs. Third, many prepaid issuers outsource almost all prepaid activity to third-party processors that include fixed costs and a mark-up in per-transaction fees. Finally, the cost data reported to the Board include information for both non-exempt and exempt cards. Exempt cards may have higher costs than non-exempt cards due to differences in the functionality of exempt cards, such as the need to verify the eligibility of transactions under certain government benefits programs. In light of the higher reported prepaid card costs, the Board specifically requests comment on whether the Board should initially have separate standards for debit card transactions and prepaid card transactions, and what those different standards should be.[60]

Safe Harbor

To further address the incentive and administrative burden problems discussed above, the Board proposes to provide a safe harbor for issuers as an alternative to the issuer-specific determination. Alternative 1 provides that, regardless of an issuer's per-transaction allowable cost, an interchange fee that is less than or equal to 7 cents per transaction is deemed to be reasonable and proportional to the issuer's cost of the electronic debit transaction. Thus, issuers would have an incentive to reduce their per-transaction costs below the safe harbor.

In determining the proposed safe harbor amount, the Board considered allowable issuer costs identified in responses to its card issuer survey. Using the issuer cost data described above, the Board proposes that 7 cents per transaction is an appropriate safe harbor value for the interchange fee. This value represents the approximate median in the distribution of estimated per-transaction variable costs. Like the cap discussed above, the Board proposes one safe harbor for all electronic debit transactions *(i.e.*, signature, PIN and prepaid). The Board recognizes that issuers' costs may change over time, and the Board proposes to re-examine the safe harbor amount periodically in light of changing issuer costs.

Overall, this approach reduces administrative burden on those issuers that choose to rely on the safe harbor, rather than determine their allowable costs, and allows issuers with costs above the safe harbor to receive an interchange fee directly linked to their costs, up to the level of the cap. At the same time, for an issuer with costs below the safe harbor value, this approach provides a reward for efficient production while also encouraging cost reductions to maximize the spread between the issuer's costs and the safe harbor value.

2. Alternative 2—Stand-Alone Cap

Under Alternative 2, the Board would use information about issuer costs to determine an appropriate maximum interchange fee, or a cap, that would apply uniformly to all issuers. That is, each issuer could receive interchange fees up to the cap, regardless of that specific issuer's actual allowable costs. Alternative 2 provides that an interchange transaction fee is reasonable and proportional to an issuer's cost only if it is no more than 12 cents per transaction. As in Alternative 1, a network would be permitted to set fees that vary with the value of the transaction (*ad valorem* fees) or with the type of transaction or type of merchant, but only such that the maximum amount of the interchange fee for any transaction was not more than the cap of 12 cents. The Board proposes the same cap of 12 cents per transaction in Alternative 2 as in Alternative 1 for the reasons stated in the discussion of Alternative 1. Each issuer's supervisor would verify that an issuer does not receive interchange revenue in excess of the cap. The Board recognizes that issuers' costs may change over time, and the Board proposes to conduct periodic surveys of covered issuers and re-examine the cap amount periodically in light of changing issuer costs.

As in Alternative 1, a stand-alone cap would encourage high-cost issuers to reduce their costs. In addition, an issuer with costs below the cap would receive a markup reflecting the spread between its costs and the cap value. Because the magnitude of the spread increases with the difference between the issuer's costs and the cap, all issuers, including low-cost issuers, would have an incentive to improve the efficiency of their operations. Finally, a cap reduces somewhat the incentive for an issuer to inflate its reported costs because no issuer would receive direct compensation for higher costs. These incentives have motivated authorities in other contexts to set price caps in many regulated industries, including, for example, the Reserve Bank of Australia in its intervention in the Australian credit and debit card markets.

In comparison to Alternative 1, administration and implementation of this approach places less administrative burden on industry participants. Although the issuer would have to report its costs to the Board every two years in accordance with § 235.8, an issuer would not have to calculate or report to the networks its maximum allowable interchange transaction fee. Similarly, a payment card network would not need to incorporate issuer-specific fees into its fee schedule, as the cap would apply uniformly to all covered issuers in that network.

3. Application of the Interchange Fee Standard

Under both Alternative 1 and Alternative 2, the limitations on interchange fees would apply on a per-transaction basis. Under both alternatives, no electronic debit transaction presented to an issuer could carry an interchange fee that exceeds the interchange fee standard for that issuer.[61] As noted above, supervisory review would be necessary to verify that an issuer does not receive interchange fee payments in excess of the maximum permitted by the rule.

This approach generally follows the statutory provisions discussed above that refer to "the" issuer and "the" transaction. The Board recognizes, however, that this approach restricts flexibility in setting interchange fees to reflect differences in risk, among other things. If the interchange fee standard must hold strictly for all transactions, then an issuer would be unable to receive a higher interchange fee for relatively high-risk transactions offset by lower interchange fees on relatively low-risk transactions.

The Board has identified two other potential methods for implementing the interchange fee standards and requests comment on each. The first approach would allow flexibility in interchange fees with respect to a particular issuer. Under this approach, the issuer could comply with the rule as long as it meets the interchange fee standard, on average, for all of its electronic debit

[60] The Board notes that prepaid cards do not currently have different interchange fees than other debit cards despite any potential differences in costs across the two types of cards.

[61] In no case does the standard prevent a network from setting interchange fees *below* the established amount. Instead, the standard describes the maximum appropriate interchange fee.

transactions over a particular network during a specified period. In other words, some interchange fees above the amount of the standard would be permitted as long as those were offset by other fees below the standard. The second approach would allow an issuer to comply with the rule with respect to transactions received over a particular network as long as, on average, over a specified period, all covered issuers on that network meet the fee standard given the network's mix of transactions. In other words, compliance with the interchange fee standard would be evaluated at the network level, rather than at the level of each individual issuer.

Both of these approaches would provide flexibility in setting interchange fees to incorporate considerations such as differences in risk across transactions. However, both of these approaches would introduce the possibility that any particular set of fees, set *ex ante* given assumptions about an issuer's or a network's expected mix of transactions, would result in an average fee for the actual transactions experienced that exceeded the regulatory standard. Moreover, network and issuer efforts to manage transactions and fees to stay within established limits could become very complex. Therefore, if the Board were to adopt either of these approaches, it may also need to deem an issuer to be in compliance with the standard as long as the interchange fees were set based on the issuer's or the network's transaction mix over a previous, designated, period of time, regardless of the actual transaction experience during the time period the fee is in effect.

The Board requests comment on whether either of these approaches is appropriate. If so, the Board requests comment about whether and how it should adopt standards with respect to a permissible amount of variation from the benchmark for any given interchange transaction fee.

4. Proposed Regulatory Language

Proposed § 235.3(a) restates the statutory requirement that the amount of any interchange transaction an issuer charges or receives with respect to a transaction must be reasonable and proportional to the cost incurred by the issuer with respect to the transaction. Proposed § 235.3(a) is the same for both Alternatives 1 and 2.

Alternative 1. Alternative 1 is contained in proposed §§ 235.3(b) through (e) of the alternative.

Interchange fee determination. Proposed § 235.3(b) sets forth the exclusive standards for determining whether the amount of any interchange fee is reasonable and proportional to the issuer's cost. Proposed § 235.3(b) sets the safe harbor amount and the issuer-specific approach, up to the cap, described above. Except during the transition period, the amount of any interchange fee must comply with the standards from October 1 of any given calendar year through September 30 of the following calendar year. *See* proposed comments 3(b)–1 through –4.

Proposed § 235.3(c) sets forth an exclusive list of allowable costs for purposes of the issuer-specific approach. Specifically, as discussed above, an issuer may include only those costs that are attributable to the issuer's role in authorization, clearance, and settlement of the transaction. Proposed § 235.3(c)(1) describes activities that comprise the issuer's role in authorization, clearance, and settlement and limits the types of costs that may be included to those that vary with the number of transactions sent to the issuer. Proposed § 235.3(c)(2) specifies that fees charged by a payment card network with respect to an electronic debit transaction are not included in the allowable costs. *See also* proposed comment 3(c)–1.

Proposed comment 3(c)–2 describes in more detail the issuer's role in authorization, clearance, and settlement of a transaction. Proposed comment 3(c)–2 also specifies the types of costs that an issuer is considered to incur for authorization, clearance, and settlement of a transaction. With respect to authorization, an issuer may include the costs of activities such as data processing, voice authorization inquiries and referral requests. *See* proposed comment 3(c)–2.i. With respect to clearance, proposed comments 3(c)–2.ii and 3(c)–2.iii clarify that an issuer's costs for clearance of routine and non-routine transactions include costs of data processing, to the extent the issuer incurs additional such costs for clearance. An issuer's clearance costs also include the costs of reconciling clearing message information, initiating the chargeback message, and data processing and reconciliation expenses specific to receiving representments and error adjustments. Finally, with respect to settlement, an issuer may include costs of interbank settlement through a net settlement service, ACH, or Fedwire® and the cost of posting the transactions to the cardholders' accounts. *See* proposed comment 3(c)–2.iv.

Proposed § 235.3(c)(1) limits allowable costs to those that vary with the number of electronic debit transactions sent to the issuer during a calendar year. Proposed comment 3(c)–3.i describes, and provides examples of, the distinction between allowable, variable costs (those costs that vary, up to existing capacity limits, with the number of transactions sent to the issuer over the calendar year) and unallowable, fixed costs (those costs that do not vary, up to existing capacity limits, with the number of transactions sent to the issuer over the calendar year).

Proposed § 235.3(c)(2) states that allowable costs do not include the fees an issuer pays to a network for processing transactions. Proposed comment 3(c)–3.ii clarifies that switch fees are an example of fees that are not an allowable cost. Proposed comment 3(c)–3.ii further explains that fees an issuer pays to a network when the network acts as the issuer's third-party processor are allowable costs.

As clarified in proposed comment 3(c)–3–iii, an issuer would not be permitted to include costs that are common to other products offered by the issuer, except insofar as those costs are allowable costs that are shared with other payment card products and vary with the number of debit transactions. Proposed comment 3(c)–3–iv clarifies that proposed § 235.3(c) sets forth an exhaustive list of allowable costs, and provides examples of costs that may not be included, such as the costs of rewards programs. The Board requests comment on whether additional clarification of allowable costs is needed.

Disclosure to payment card network. Each issuer must ensure that it is in compliance with proposed § 235.3(a) by receiving or charging interchange transaction fees at or below the safe harbor amount or as determined by its allowable costs up to the cap. Because payment card networks, not issuers, establish interchange fees, issuers must provide networks with information sufficient to ensure the issuers' compliance. Proposed § 235.3(d) requires an issuer to report the maximum amount of an interchange transaction fee it may receive or charge to a network, but only if the issuer will be receiving or charging an interchange fee above the safe harbor amount.

In establishing the conditions for reporting, the Board recognizes that not all networks likely will establish individualized interchange transaction fees. If a network does not establish individualized interchange transaction fees above the safe harbor amount, the Board believes it is not necessary to require an issuer to report its maximum allowable interchange transaction fee to networks through which it receives

electronic debit transactions. *See* proposed comment 3(d)–1. The Board requests comment on whether this reporting requirement is necessary to enable networks to set issuer-specific interchange fees.

The Board proposes that an issuer report its maximum allowable interchange fee to each payment card network through which it processes transactions by March 31 of each year (based on the costs of the previous calendar year) to ensure compliance with the standard beginning on October 1 of that same year. *See* proposed comment 3(d)–2. The Board specifically requests comment on whether prescribing the deadline by rule is necessary. If necessary, the Board requests comment on whether March 31 is an appropriate deadline or whether a different deadline is appropriate.

Transition period. As noted above, the Board is proposing to allow three months after year-end for an issuer to determine and report its maximum allowable interchange transaction fee, if its payment card networks establish individualized interchange fees above the safe harbor amount. The new interchange fee standards will be effective July 21, 2011, and are proposed to be based on 2009 costs. The Board believes that establishing new interchange fees based on calendar year 2010 costs on September 30, 2011 (approximately two months after the effective date) will impose an unnecessary burden on issuers, payment card networks, and acquirers. Accordingly, the Board proposes to allow issuers to rely on calendar year 2009 costs until September 30, 2012. After that date, issuers must determine compliance based on calendar year 2011 costs.

Alternative 2. Alternative 2 is contained in proposed § 235.3(b). That section prohibits an issuer from receiving or charging any interchange transaction fee greater than 12 cents. *See* proposed comment 3(b)–1 under Alternative 2.

IV. Section 235.4 Adjustment for Fraud-Prevention Costs

Section 920(a)(5) of the statute provides that the Board may allow for an adjustment to the interchange fee amount received or charged by an issuer if (1) such adjustment is reasonably necessary to make allowance for costs incurred by the issuer in preventing fraud in relation to electronic debit card transactions involving that issuer, and (2) the issuer complies with fraud-prevention standards established by the Board.[62] Those standards must be designed to ensure that any adjustment is limited to the issuer's fraud-prevention costs for electronic debit transactions; takes into account any fraud-related reimbursements received from consumers, merchants, or payment card networks in relation to electronic debit transactions involving the issuer; and requires issuers to take effective steps to reduce the occurrence of, and costs from, fraud in relation to electronic debit transactions, including through the development and implementation of cost-effective fraud-prevention technology.

In issuing the standards and prescribing regulations for the adjustment, the Board must consider (1) The nature, type, and occurrence of fraud in electronic debit transactions; (2) the extent to which the occurrence of fraud depends on whether the authorization in an electronic debit transaction is based on a signature, PIN, or other means; (3) the available and economical means by which fraud on electronic debit transactions may be reduced; (4) the fraud-prevention and data-security costs expended by each party involved in the electronic debit transactions (including consumers, persons who accept debit cards as a form of payment, financial institutions, retailers, and payment card networks); (5) the costs of fraudulent transactions absorbed by each party involved in such transactions (including consumers, persons who accept debit cards as a form of payment, financial institutions, retailers, and payment card networks); (6) the extent to which interchange transaction fees have in the past reduced or increased incentives for parties involved in electronic debit transactions to reduce fraud on such transactions; and (7) such other factors as the Board considers appropriate.

For the reasons set forth below, the Board has not proposed specific regulatory provisions to implement an adjustment for fraud-prevention costs to the interchange transaction fee. The Board, however, sets forth two approaches—a technology-specific approach and a non-prescriptive approach—to designing the adjustment framework and requests comment on several questions related to these approaches. The Board plans to consider the comments in developing a specific proposal for further public comment.

A. Background and Survey Results

Although the statute authorizes the Board to allow an adjustment to an interchange fee for fraud-prevention costs, the statute does not define the term "fraud." In considering whether to allow an adjustment, the Board believes that fraud in the debit card context should be defined as the use of a debit card (or information associated with a debit card) by a person, other than the cardholder, to obtain goods, services, or cash without authority for such use.[63]

Two primary steps are involved in making fraudulent purchases using a debit card. The first is stealing the cardholder account data. The second is using the stolen card or account data to make the fraudulent transaction. A thief may steal the card or the account information in several ways. For example, a card may be lost or stolen, and a thief may simply use the card to make purchases. Alternatively, a thief could obtain card account data by breaching the data-security systems of any entity that maintains records of debit card data. A thief might use the card account data to create a counterfeit card. The stolen card or account data may also be used to make unauthorized card-not-present transactions via the Internet, phone, or mail-order purchases.

As part of its survey of debit card issuers, payment card networks, and merchant acquirers, the Board gathered information about the nature, type, and occurrence of fraud in electronic debit transactions at the point of sale, and the losses due to fraudulent transactions absorbed by parties involved in such transactions.[64] Respondents were asked to report this information separately for signature and PIN debit card programs.[65] From the surveys, the Board estimates that industry-wide fraud losses to all parties of a debit card transaction were approximately $1.36 billion in 2009.[66] About $1.15 billion of these losses arose from signature debit

[62] In describing Section 1075 of the Dodd-Frank Act, Senator Durbin stated: "Further, any fraud prevention cost adjustment would be made on an issuer-specific basis, as each issuer must individually demonstrates that it complies with the standards established by the Board, and as the adjustment would be limited to what is reasonably necessary to make allowance for fraud-prevention costs incurred by that particular issuer." 156 Cong. Rec. S5925 (July 15, 2010).

[63] This definition derives from the EFTA's definition of "unauthorized electronic fund transfer." 15 U.S.C. 1693a(11).

[64] Respondents were not asked to provide data on ATM fraud.

[65] For more information, see the previous discussion regarding the survey process.

[66] Industry-wide fraud losses were extrapolated from data reported in the issuer and network surveys. Of the 89 issuers who responded to the issuer survey, 38 issuers provided data on total fraud losses related to their electronic debit card transactions. These issuers reported $719 million in total fraud losses to all parties of card transactions and represented 53 percent of the total transactions reported by networks.

card transactions and about $200 million arose from PIN debit card transactions.[67]

The surveys also solicited information about respondents' fraud-prevention and data-security activities and the costs of these activities. The surveys did not capture analogous activities and costs for merchants (or cardholders). The data presented below derive from the survey of debit card issuers, which has the most complete information about fraud losses.[68] The data are estimates given the variability in reporting across issuers about fraud types, associated fraud losses, and fraud-prevention and data-security activities and costs.

Issuers that provided data on total fraud losses relating to their electronic debit card transactions reported $719 million in total debit card fraud losses to all parties, averaging 0.041 percent of transaction volume and 9.4 basis points of transaction value. These fraud losses were generally associated with 10 different types of fraud. The most commonly reported fraud types were counterfeit card fraud, lost and stolen card fraud, and card-not-present fraud.

Issuers reported that total signature and PIN debit card fraud losses to all parties averaged 13.1 and 3.5 basis points, respectively. This represents, on a per-dollar basis, signature debit fraud losses 3.75 times PIN-debit fraud losses. These different fraud rates reflect, in part, differences in the ease of fraud associated with the two authorization methods. A signature debit card transaction requires information that is typically contained on the card itself in order for card and cardholder authentication to take place. Therefore, a thief only needs to steal information on the card in order to commit fraud.[69] In contrast, a PIN debit card transaction requires not only information contained on the card itself, but also something only the cardholder should know, namely the PIN. In this case, a thief needs both the information on the card and the cardholder's PIN to commit fraud.

Signature debit card transactions exhibit a higher fraud rate than that of PIN debit card transactions. Debit cards used to make purchases over the Internet and in other card-not-present environments are routed almost exclusively over signature debit card networks.[70] Although card-not-present transactions have a higher fraud rate than card-present transactions, the average signature debit fraud loss for card-present transactions is nonetheless more than 4 times that for PIN debit transactions.[71]

In terms of losses to the various parties in a transaction, almost all of the reported fraud losses associated with debit card transactions fall on the issuers and merchants. In particular, across all types of transactions, 57 percent of reported fraud losses were borne by issuers and 43 percent were borne by merchants. In contrast, most issuers reported that they offer zero or very limited liability to cardholders, in addition to regulatory protections already afforded to consumers, such that the fraud loss borne by cardholders is negligible.[72] Payment card networks and merchant acquirers also reported very limited fraud losses for themselves.

The distribution of fraud losses between issuers and merchants depends, in part, on the authorization method used in a debit card transaction. Issuers and payment card networks reported that nearly all the fraud losses associated with PIN debit card transactions (96 percent) were borne by issuers. In contrast, reported fraud losses were distributed much more evenly between issuers and merchants for signature debit card transactions. Specifically, issuers and merchants bore 55 percent and 45 percent of signature debit fraud losses, respectively.

In general, merchants are subject to greater liability for fraud in card-not-present transactions than in card-present transactions. As noted above, signature-based authorization is currently the primary means to perform such transactions. According to the survey data, merchants assume approximately 76 percent of signature debit card fraud for card-not-present transactions.

Based on the card issuer survey data, issuers engage in a variety of fraud-prevention activities. Issuers identified approximately 130 fraud-prevention activities and reported the costs associated with these activities as they relate to debit card transactions.[73] Some of these activities were broadly related to fraud detection and included activities such as transaction monitoring and fraud risk scoring systems that may trigger an alert or call to the cardholder in order to confirm the legitimacy of a transaction. Issuers also reported a number of fraud mitigation activities, such as merchant-blocking and account-blocking. Some issuers included costs related to customer servicing associated with fraudulent transactions and personnel costs for fraud investigation teams or other staffing costs. When all fraud-prevention activities reported by issuers are included, the overall amount spent by respondents was approximately 1.6 cents per transaction, which also corresponds to the median amount spent by those firms.

The survey also asked issuers to report their data-security activities and costs. Issuers identified approximately 50 data-security activities and reported the allocated costs to debit card programs.[74] Many of these activities were associated with information and system security. For all data-security costs reported by issuers in the card issuer survey, the overall amount spent by respondents was approximately 0.2 cents per transaction, which corresponds to the median amount spent by those firms.[75]

Merchants also have fraud-prevention and data-security costs, including costs related to compliance with payment card industry data-security standards (PCI–DSS) and other tools to prevent fraud, such as address verification services or internally developed fraud screening models, particularly for card-not-present transactions.[76] The Board's

[67] 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.

[68] Networks' information regarding fraud losses may not be as complete as that of issuers because fraud losses absorbed by the issuers would generally not flow through the networks as chargebacks and may not be fully reported to the networks. Acquirers would generally not have knowledge about issuer losses.

[69] Among other things, information on the card includes the card number, the cardholder's name, and the cardholder's signature.

[70] Although some recent innovations attempt to facilitate PIN entry for Internet transactions, use of these technologies is still very limited.

[71] This comparison is based on survey responses from those issuers that differentiated card-present and card-not-present fraud losses for both signature and PIN transactions. These respondents represent about half of the transaction volume reported by all issuer respondents. The ratio of card-present fraud losses for signature and PIN debit networks is not comparable to the ratio of total fraud losses noted above because they are based on different subsets of issuer respondents.

[72] The EFTA limits consumer liability for unauthorized electronic fund transfers. *See* 15 U.S.C. 1693g and 12 CFR 205.6.

[73] The Board does not believe that the issuers participated in 130 unique fraud-prevention activities. Rather, the Board believes that the listed activities refer to many of the same activities under differing descriptions.

[74] Similar to the fraud-prevention information, the Board does not believe that issuers engaged in a total of 50 unique activities.

[75] On average, by transaction type, issuers incurred 2.2¢ per signature-debit transaction for fraud-prevention and data-security activities and 1.2¢ per PIN-debit transaction. Similarly, networks incurred 0.7¢ per signature-debit transaction for fraud-prevention and data-security activities and 0.6¢ per PIN-debit transaction. Finally, acquirers incurred 0.4¢ per signature-debit transaction for fraud-prevention and data-security activities and 0.3¢ per PIN-debit transaction.

[76] The Payments Cards Industry (PCI) Security Standards Council was founded in 2006 by five

Continued

surveys were not comprehensive enough to adequately capture merchant activities nor did they provide a way to determine whether issuers' fraud-prevention and data-security activities directly benefit merchants by reducing their debit card fraud losses.

B. Board's Consideration of an Adjustment for Fraud-Prevention Costs

As previously described, issuers, merchant acquirers, and networks listed a variety of fraud-prevention and data-security activities in their survey responses. In designing an adjustment framework for fraud-prevention costs, the Board is considering how an adjustment should be implemented, what fraud-prevention costs such an adjustment should cover, and what standards the Board should prescribe for issuers to meet as a condition of receiving the adjustment.

Technology-specific approach. One approach to an adjustment for fraud-prevention costs would be to allow issuers to recover costs incurred for implementing major innovations that would likely result in substantial reductions in fraud losses. This approach would establish technology-specific standards that an issuer must meet to be eligible to receive the adjustment to the interchange fee. Under this approach, the Board would identify the paradigm-shifting technology(ies) that would reduce debit card fraud in a cost-effective manner. The adjustment would be set to reimburse the issuer for some or all of the costs associated with implementing the new technology, perhaps up to a cap; therefore, covered issuers and the Board would need to estimate the costs of implementing the new technology in order to set the adjustment correctly. Industry representatives have highlighted several fraud-prevention technologies or activities, such as end-to-end encryption, tokenization, chip and PIN, and the use of dynamic data that they believe have the potential to substantially reduce fraud losses. These technologies are not broadly used in the United States at this time.[77]

This approach to implementing the adjustment has the potential to spur implementation of major security enhancements in the debit card market that have not yet gained substantial market adoption. Specifically, the adjustment could serve as an incentive for debit card industry participants to coordinate in the adoption of technologies that the Board determines would be effective in reducing fraud losses. The drawback of adopting technology-specific standards is the risk that it would cause issuers to under-invest in other innovative new technologies, not included in the Board's standards, that may be more effective and less costly than those identified in the standards.

Non-prescriptive approach. An alternative approach is to establish a more general standard that an issuer must meet to be eligible to receive an adjustment for fraud-prevention costs. Such a standard could require issuers to take steps reasonably necessary to maintain an effective fraud-prevention program but not prescribe specific technologies that must be employed as part of the program.[78] This approach would ensure that the Board's standards give flexibility in responding to emerging and changing fraud risks.

Under this approach, the adjustment would be set to reimburse the issuer for some or all of the costs of its current fraud-prevention and data-security activities and of research and development for new fraud-prevention techniques, perhaps up to a cap. This approach would shift some or all of the issuers' ongoing fraud-prevention costs to merchants, even though many merchants already bear substantial card-related fraud-prevention costs, particularly for signature debit transactions.[79] Such a shift in cost provides issuers with additional incentives to invest in fraud-prevention measures. Financial institutions make investments today, however, to reduce the risk of fraud in non-card forms of payment, without reimbursement of those costs from the counterparty to the payment.

Request for Comment

The Board requests comment on how to implement an adjustment to interchange fees for fraud-prevention costs. In particular, the Board is interested in commenters' input on the following questions:

1. Should the Board adopt technology-specific standards or non-prescriptive standards that an issuer must meet in order to be eligible to receive an adjustment to its interchange fee? What are the benefits and drawbacks of each approach? Are there other approaches to establishing the adjustment standards that the Board should consider?

2. If the Board adopts technology-specific standards, what technology or technologies should be required? What types of debit-card fraud would each technology be effective at substantially reducing? How should the Board assess the likely effectiveness of each fraud-prevention technology and its cost effectiveness? How could the standards be developed to encourage innovation in future technologies that are not specifically mentioned?

3. If the Board adopts non-prescriptive standards, how should they be set? What type of framework should be used to determine whether a fraud-prevention activity of an issuer is effective at reducing fraud and is cost-effective? Should the fraud-prevention activities that would be subject to reimbursement in the adjustment include activities that are not specific to debit-card transactions (or to card transactions more broadly)? For example, should know-your-customer due diligence performed at account opening be subject to reimbursement under the adjustment? If so, why? Are there industry-standard definitions for the types of fraud-prevention and data-security activities that could be reimbursed through the adjustment? How should the standard differ for signature- and PIN-based debit card programs?

4. Should the Board consider adopting an adjustment for fraud-prevention costs for only PIN-based debit card transactions, but not signature-based debit card transactions, at least for an initial adjustment, particularly given the lower incidence of fraud and lower chargeback rate for PIN-debit transactions? To what extent

card networks—Visa, Inc., MasterCard Worldwide, Discover Financial Services, American Express, and JCB International. These card brands share equally in the governance of the organization, which is responsible for the development and management of PCI Data Security Standards (PCI DSS). PCI DSS is a set of security standards that all payment system participants, including merchants and processors, are required to meet in order to participate in payment card systems.

[77] The Board understands, however, that in countries with broad chip and PIN adoption, fraud levels are not necessarily lower than those experienced in the U.S. because fraud has migrated to less secure channels, for example to Internet transactions where PIN authentication is not yet a common option.

[78] For example, Section 615(e) of the Fair Credit Reporting Act requires a number of federal agencies to develop identity theft prevention guidelines and regulations. The implementing regulations require that covered institutions adopt an identity theft prevention program designed to identify, detect, and respond to relevant identity theft red flags, but does not require consideration of specific red flags or mandate the use of specific fraud-prevention solutions. Rather, the accompanying guidelines provide factors that institutions should "consider." The supplement to the guidelines lists examples of red flags. *See e.g.,* Regulation V (Fair Credit Reporting), 12 CFR 222.90(d).

[79] An issuer's fraud losses would not be considered a cost that would be considered in setting the fraud adjustment. EFTA limits any fraud adjustment to an amount that "is reasonably necessary to make allowance for costs incurred by the issuer in *preventing* fraud in relation to electronic debit transactions * * *" EFTA Section 920(a)(5)(A)(i) (emphasis added).

would an adjustment applied to only PIN-based debit card transactions (1) satisfy the criteria set forth in the statute for establishing issuer fraud-prevention standards, and (2) give appropriate weight to the factors for consideration set forth in the statute?[80]

5. Should the adjustment include only the costs of fraud-prevention activities that benefit merchants by, for example, reducing fraud losses that would be eligible for chargeback to the merchants? If not, why should merchants bear the cost of activities that do not directly benefit them? If the adjustment were limited in this manner, is there a risk that networks would change their rules to make more types of fraudulent transactions subject to chargeback?

6. To what extent, if at all, would issuers scale back their fraud-prevention and data-security activities if the cost of those activities were not reimbursed through an adjustment to the interchange fee?

7. How should allowable costs that would be recovered through an adjustment be measured? Do covered issuers' cost accounting systems track costs at a sufficiently detailed level to determine the costs associated with individual fraud-prevention or data-security activities? How would the Board determine the allowable costs for prospective investments in major new technologies?

8. Should the Board adopt the same implementation approach for the adjustment that it adopts for the interchange fee standard, that is, either (1) an issuer-specific adjustment, with a safe harbor and cap, or (2) a cap?

9. How frequently should the Board review and update, if necessary, the adjustment standards?

10. EFTA Section 920 requires that, in setting the adjustment for fraud-prevention costs and the standards that an issuer must meet to be eligible to receive the adjustment, the Board should consider the fraud-prevention and data-security costs of each party to the transaction and the cost of fraudulent transactions absorbed by each party to the transaction. How should the Board factor these considerations into its rule? How can the Board effectively measure fraud-prevention and data-security costs of the 8 million merchants that accept debit cards in the United States?

V. Sec. 235.5 Exemptions

EFTA Section 920(a) sets forth several exemptions to the applicability of the interchange fee restriction provisions. Specifically, the statute contains exemptions for small issuers as well as government-administered payment programs and certain reloadable prepaid cards.[81] The Board proposes to implement these exemptions in § 235.5, as discussed below.

Under the proposed rule, an electronic debit transaction may qualify for more than one exemption. For example, an electronic debit transaction made using 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 issuer that, together with its affiliates, has assets of less than $10 billion as of the end of the previous calendar year. Proposed comment 5–1 clarifies that an issuer only needs to qualify for 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 clarifies that a payment card network establishing interchange fees 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.

A. Sec. 235.5(a) Exemption for Small Issuers

Section 920(a)(6)(A) of the EFTA provides that EFTA Section 920(a) does not apply to any issuer that, together with its affiliates, has assets of less than $10 billion. For purposes of this provision, the term "issuer" is limited to the person holding the asset account that is debited through an electronic debit transaction.[82]

Proposed § 235.5(a)(1) combines the statutory language in EFTA Sections 920(a)(6)(A) and (B) to implement the exemption with some minor adjustments for clarity and consistency. Therefore, § 235.5(a)(1) provides 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 clarifies 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.

For consistency, the proposed rule assesses an issuer's asset size for purposes of the small issuer exemption at a single point in time. Although the asset size of an issuer and its affiliates will fluctuate over time, for purposes of determining an issuer's eligibility for this exemption, the Board believes the relevant time for determining the asset size of the issuer and its affiliates for purposes of this exemption should be the end of the previous calendar year. The Board has used the calendar year-end time frame in other contexts for determining whether entities meet certain dollar thresholds.[83]

To the extent that a payment card network permits issuers meeting the small issuer exemption to receive higher interchange fees than allowed under §§ 235.3 and 235.4, payment card networks, as well as merchant acquirers and processors, may need a process in place to identify such issuers. Thus, the Board requests comment on whether the rule should establish a consistent 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. For example, the rule could require an issuer to notify the payment card network within 90 days of the end of the preceding calendar year in order to be eligible for an exemption for the next rate period. The Board also requests comment on whether it should permit payment card networks to develop their own processes for making this determination.

B. Sec. 235.5(b) Exemption for Government-Administered Programs

Under EFTA Section 920(a)(7)(A)(i), 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

[80] Some merchant representatives have advocated that the fraud adjustment not be used to perpetuate signature-based networks, which they believe are inherently less secure than PIN networks and for which they incur significantly more chargebacks. These merchants believe that, if the Board allows a fraud adjustment, it should be designed to steer the industry from signature debit to PIN debit, or possibly to other more secure means of authorizing transactions. As noted earlier, the survey data indicate that signature debit fraud losses are higher than PIN debit fraud losses and that merchants bear a very small proportion of loss associated with PIN debit transactions.

[81] EFTA Section 920(a)(6) and (7) (15 U.S.C. 1693r(a)(6) and 7).

[82] EFTA Section 920(a)(6)(B) (15 U.S.C. 1693r(a)(6)(B)). The Board notes that an issuer of decoupled debit cards, which are debit cards where the issuer 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.

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

Federal, State, or local government-administered payment program is generally exempt from the interchange fee restrictions. However, the exemption applies as long as a person may only use the debit or general-use prepaid card to transfer or debit funds, monetary value, or other assets that have been provided pursuant to such program. The Board proposes to implement this provision in § 235.5(b)(1) with minor non-substantive changes to the statutory language.

Proposed comment 5(b)–1 clarifies the meaning of a government-administered program. The proposed comment states that 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 service providers that act on behalf of the government agency. The Board understands that for many government-administered programs, the government agency outsources the administration of the card program to third parties. The proposed comment makes clear that a government-administered program will still be deemed government-administered regardless of the government agency's choice to use a third party for any and all aspects of the program.

Furthermore, proposed comment 5(b)–1 provides that 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, the Board understands that for child support programs, a Federal, State, or local government agency is not the source of funds, but such programs are nevertheless administered by State governments. As such, the Board believes that cards distributed in connection with such programs would fall under the exemption.

The Board notes that 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 the exemption under EFTA Section 920(a)(7)(i). Because proposed § 235.5(b)(1), which implements EFTA Section 920(a)(7)(i), covers these and other government-administered systems, neither the proposed regulation nor commentary specifically references such programs.

Payment card networks that allow issuers to charge higher interchange fees than permitted under §§ 235.3 and 235.4 for transactions made using a debit card that meets the exemption for government-administered payment programs will need a means to identify the card accounts that meet the exemption. As with the small issuer exemption in § 235.5(a), the Board requests comment on whether it should establish a certification process or whether it should permit payment card networks to develop their own processes.

The operational aspects of certifying on an account-by-account basis may be more complex than certifying on an issuer-by-issuer basis. Therefore, if the Board is to establish a certification process, the Board requests comment on how to structure this process, including the time periods for reporting and what information may be needed to identify accounts to which the exemption applies. For example, the Board understands that certain cards issued under a government-administered payment program may be distinguished by the BIN or BIN range.

C. Sec. 235.5(c) Exemption for Certain Reloadable Prepaid Cards

EFTA Section 920(a)(7)(A)(ii) establishes an exemption for an interchange transaction fee charged or received with respect to an electronic debit transaction for a plastic card, or other 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.

For clarity, the proposed rule refers to "general-use prepaid card," which incorporates certain of the conditions for obtaining the exemption in EFTA Section 920(a)(7)(A)(ii). *See* proposed § 235.2(i). Proposed § 235.5(c)(1) thus implements the remaining conditions concerning the ability of the card to be used to access an 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) and whether the card is reloadable and not marketed or labeled as a gift card or gift certificate.

Typically, issuers structure prepaid card programs so that the funds underlying each prepaid card in the program are held in an omnibus account, and the amount attributable to each prepaid card is tracked by establishing subaccounts or by other recordkeeping means. However, certain issuers structure prepaid card programs differently such that the funds underlying each card are attributed to separate accounts established by the issuer.

The condition in EFTA Section 920(a)(7)(A)(ii)(II) makes clear that an exempt card may not be issued or approved for use to access or debit an account held by or for the benefit of the cardholder (other than a subaccount or other method recording or tracking funds purchased or loaded on the card on a prepaid basis). Therefore, issuers that structure prepaid card programs such that the funds underlying each card are attributed to separate accounts do not qualify for the exemption based on the conditions set forth under the statute. These issuers may argue that there is little difference between their prepaid programs and others that are constructed so that the funds are part of an omnibus account. However, an argument can be made that prepaid cards that access separate accounts are not significantly different from debit cards that access demand deposit accounts, which are covered by the interchange fee restrictions in EFTA Section 920(a). The Board's proposal is based on the view that prepaid cards where the underlying funds are held in separate accounts do not qualify for the exemption.

Reloadable and Not Marketed or Labeled as a Gift Card or Gift Certificate

The Board has previously defined and clarified the meaning of "reloadable and not marketed or labeled as a gift card or gift certificate" in the context of a rule restricting the fees and expiration dates for gift cards under 12 CFR 205.20 ("Gift Card Rule"). In order to maintain consistency, the Board proposes to import commentary related to the meaning of reloadable and not marketed or labeled as a gift card or gift certificate from the Gift Card Rule.

Proposed comment 5(c)–1 provides that 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 after the initial purchase or issuance. The comment further states that 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. The comment is similar to comment 20(b)(2)–1 under the Gift Card Rule.

Proposed comment 5(c)–2, which has been adapted from comment 20(b)(2)–2 under the Gift Card Rule, clarifies the meaning of the term "marketed or labeled as a gift card or gift certificate." The proposed comment provides that the term means directly or indirectly offering, advertising, or otherwise suggesting the potential use of a general-use prepaid card as a gift for another person. The proposed comment also states that whether the exclusion applies does not depend on the type of entity that is making the promotional message. Therefore, under the proposed comment, a general-use prepaid card is deemed to be marketed or labeled as a gift card or gift certificate if anyone (other than the consumer-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.[84]

The proposed comment also states that a certificate or card could be deemed to be marketed or labeled as a gift card or gift certificate even if it is primarily marketed for another purpose. Thus, for example, a reloadable network-branded card would be considered to be marketed or labeled as a gift card or gift certificate even 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. Proposed comment 5(c)–2 further clarifies that the mere mention that gift cards or gift certificates are available 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.

The Board also proposes examples of what the term "marketed or labeled as a gift card or gift certificate" includes and does not include in proposed comment 5(c)–3; these examples are similar to those in comment 20(b)(2)–3 under the Gift Card Rule. Thus, under the proposed comment, examples of marketing or labeling as a gift card or gift certificate include displaying the word "gift" or "present," displaying a holiday or congratulatory message, and incorporating gift-giving or celebratory imagery or motifs on the card, certificate or accompanying material, such as documentation, packaging and promotional displays. *See* proposed comment 5(c)–3.i.

The proposed comment further states that a general-use prepaid card is not marketed or labeled as a gift card or gift certificate if the issuer, seller, or other person represents that the card can be used as a substitute for a checking, savings, or deposit account, as a budgetary tool, or to cover emergency expenses. Similarly, the proposed comment provides that a card is not marketed as a gift card or gift certificate if it is promoted as a substitute for travelers checks or cash for personal use, or promoted as a means of paying for a consumer's health-related expenses. *See* proposed comment 5(c)–3.ii.

As the Board discussed in connection with the issuance of the Gift Card Rule, there are several different models for how prepaid cards may be distributed from issuers to consumers.[85] These models vary in the amount of control the issuer has in terms of how these products may be marketed to consumers. Therefore, an issuer that does not intend to market a particular general-use prepaid card as a gift card or gift certificate could find its intent thwarted by the manner in which a retailer displays the card in its retail outlets.

The Board issued comment 20(b)(2)–4 under the Gift Card Rule to address these issues. Specifically, comment 20(b)(2)–4 provides that a product is not marketed or labeled as a gift card or gift certificate if persons subject to the Gift Card Rule, 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 card, or other payment code or device, 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 card, or other payment code or device, is not being marketed as a gift card or gift certificate. The comment further states that whether a person has marketed a reloadable card, or other payment code or device, as a gift card or gift certificate will depend on the facts and circumstances, including whether a reasonable consumer would be led to believe that the card, or other payment code or device, is a gift card or gift certificate. The comment also included examples. The Board is proposing a similar comment 5(c)–4 to address 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. Proposed comment 5(c)–4 also contains similar examples as set forth in comment 20(b)(2)–4 under the Gift Card Rule.

Proposed comment 5(c)–5 provides guidance relating to online sales of gift cards that is substantially the same as in comment 20(b)(2)–5 under the Gift Card Rule. As discussed in connection with the issuance of the Gift Card Rule, the Board believes that a Web site's display of a banner advertisement or a graphic on its home page that prominently displays "Gift Cards," "Gift Giving," or similar language without mention of other available products, or inclusion of the terms "gift card" or "gift certificate" in its web address, creates the same potential for consumer confusion as a sign stating "Gift Cards" at the top of a prepaid card display. Because a consumer acting reasonably under these circumstances may be led to believe that all prepaid products sold on the Web site are gift cards or gift certificates, the Web site is deemed to have marketed all such products, including any general-purpose reloadable cards that may be sold on the Web site, as gift cards or gift certificates. Proposed comment 5(c)–5 provides that products sold by such Web sites would not be eligible for the exemption.

Certification

As with the exemption for government-administered payment programs, payment card networks, as well as merchant acquirers and processors, will need a process to identify accounts accessed by reloadable general-use prepaid cards that are not marketed or labeled as a gift card or gift certificate if such networks permit issuers of such accounts to charge interchange fees in excess of the amount permitted under §§ 235.3 and 235.4. The Board seeks comment on whether it should establish a certification process for the reloadable prepaid cards exemption or whether it should permit payment card networks to develop their own processes. The Board also requests comment on how it should structure the certification process if it were to establish a process, including the time

[84] As the Board discussed in connection with the issuance of the Gift Card Rule, a card is not deemed to be marketed or labeled as a gift card or gift certificate as a result of actions by the consumer-purchaser. For example, if the purchaser gives the card to another consumer as a "gift," or if the primary cardholder contacts the issuer and requests a secondary card to be given to another person for his or her use, such actions do not cause the card to be marketed as a gift card or gift certificate.

[85] *See* 75 FR 16580 at 16594 (April 1, 2010).

periods for reporting and what information may be needed to identify accounts to which the exemption applies.

Temporary Cards Issued in Connection With a General-Purpose Reloadable Card

As the Board discussed in connection with the Gift Card Rule, some general-purpose reloadable cards may be sold initially as a temporary non-reloadable card. These cards are usually marketed as an alternative to a bank account (or account substitute). After the card is purchased, the cardholder may call the issuer to register the card. Once the issuer has obtained the cardholder's personal information, a new personalized, reloadable card is sent to the cardholder to replace the temporary card.

The Board decided to permit temporary non-reloadable cards issued solely in connection with a general-purpose reloadable card to be treated as general-purpose reloadable cards under the Gift Card Rule despite the fact that such cards are not reloadable. As it discussed in connection with the Gift Card Rule, the Board was concerned that covering temporary non-reloadable cards under the Gift Card Rule would create regulatory incentives that would unduly restrict issuers' ability to address potential fraud. Some issuers issue temporary cards in non-reloadable form to encourage consumers to register the card and provide customer identification information for Bank Secrecy Act purposes. A rule that provides that the exemption is only available if the temporary card is reloadable would therefore limit issuers' options without a corresponding benefit.[86]

For similar reasons, the Board is proposing that interchange fees charged or received with respect to transactions using a temporary non-reloadable card issued solely in connection with a general-purpose reloadable card would also qualify for the exemption under EFTA Section 920(a)(7)(A)(ii), provided such cards are not marketed or labeled as a gift card or gift certificate. Therefore, proposed § 235.5(c)(2) provides that the term "reloadable" also includes a temporary non-reloadable card if it is issued solely in connection with a reloadable general-use prepaid card. 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.

[86] *See* 75 FR 16580 at 16596 (April 1, 2010).

D. Sec. 235.5(d) Exception

EFTA Section 920(a)(7)(B) provides that after the end of the one-year period beginning on the effective date of the statute, the exemptions available under EFTA Sections 920(a)(7)(A)(i) and (ii) become subject to an exception. The statute provides that the exemptions are not available if any of the following fees may be charged to a person with respect to the card: (i) An overdraft fee, including a shortage of funds or a transaction processed for an amount exceeding the account balance; and (ii) a fee charged by the issuer for the first withdrawal per month from an ATM that is part of the issuer's designated ATM network. The Board proposes to implement this exception to the exemptions in § 235.5(d), substantially as presented in the statute with one minor clarification.

Specifically, the Board proposes to clarify that the fee described in § 235.5(d)(1) does not include a fee or charge charged 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.

VI. Sec. 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)(8) authorizes the Board to prescribe rules to ensure that network fees are not used "to directly or indirectly compensate an issuer with respect to an electronic debit transaction" and "to circumvent or evade" the interchange transaction fee restrictions under the statute and this proposed rule.[87] In addition, EFTA Section 920(a)(1) provides the Board authority to prescribe rules to prevent other forms of circumvention or evasion. Pursuant to both of these authorities, the Board is proposing to prohibit circumvention or evasion of the interchange transaction fee restrictions in §§ 235.3 and 235.4. Circumvention or evasion would occur under the proposed rule if an issuer receives net compensation from a payment card network, not considering interchange transaction fees received from acquirers.

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.[88] 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 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 on 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. For a closed-loop or three-party payment network, network fees are bundled into the merchant discount rate charged by the network in its capacity as the merchant acquirer.

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. While interchange fee rates generally do not vary across issuers or acquirers for the same types of debit card transactions, fees charged by the network are often set on an issuer-by-issuer or merchant-by-merchant basis. For example, issuers and merchants may be given individualized discounts relative to a published network fee or rate based on their transaction volume increases.

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

[87] 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."

[88] Network fees associated with authorizing, clearing, and settling debit card transactions are not included in the allowable costs under the interchange standard.

upon contract execution or renewal. 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 among 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 the network to encourage specific processing behavior, such as the use of enhanced authorization methods or the deployment of additional merchant terminals.

There are a number of factors that a network may consider in calibrating the appropriate level of network fees, discounts, and incentives in order to achieve network objectives. However, EFTA Section 920(a) authorizes the Board to prescribe rules to ensure that such pricing mechanisms are not used to circumvent or evade the interchange transaction fee restrictions. This authority is both specific with respect to the use of network fees under EFTA Section 920(a)(8), as well as general with respect to the Board's implementation of the interchange transaction fee restrictions under EFTA Section 920(a)(1).

As an initial matter, the Board notes that the statute does not directly regulate the amount of network fees that a network may charge for any of its services. Thus, the proposed rule does not seek to set or establish the level of network fees that a network may permissibly impose on any network participant for its services. Instead, the proposed rule is intended to ensure that network fees, discounts, and incentives do not, in effect, circumvent the interchange transaction fee restrictions. Accordingly, proposed § 235.6 contains a general prohibition against circumventing or evading the interchange transaction fee restrictions in §§ 235.3 and 235.4. In addition, proposed § 235.6 would expressly prohibit an issuer from receiving net compensation from a payment card network with respect to electronic debit transactions. The Board believes that such compensation would effectively serve as a transfer to issuers in excess of the amount of interchange transaction fee revenue allowed under the standards in §§ 235.3 and 235.4.

The Board also considered whether increases in fees charged by the network on merchants or acquirers coupled with corresponding decreases in fees charged by the network on 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.

The Board recognizes that such decreases in issuer fees could have the effect of offsetting reductions in interchange transaction fee revenue that will occur under the proposed restrictions in §§ 235.3 and 235.4. Nonetheless, the Board believes that such circumstances would not necessarily indicate circumvention or evasion of the interchange transaction fee restrictions because, absent net payments to the issuer from the network, an issuer would not receive net compensation from the network for electronic debit transactions. Moreover, the Board is concerned that prohibiting 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. The Board requests comment on the proposed approach, as well as on any other approaches that may be necessary and appropriate to address concerns about circumvention or evasion of the interchange fee standards.

Proposed comment 6–1 provides that any finding of circumvention or evasion of the interchange transaction fee restrictions will depend on the relevant facts or circumstances. The proposed comment also provides an example of a circumstance indicating circumvention or evasion. In the example, circumvention or evasion occurs if the total amount of payments or incentives received by an issuer from a payment card network during a calendar year in connection with electronic debit transactions, 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 during that year. In this circumstance, an issuer impermissibly receives net compensation from the payment card network in addition to the interchange transaction fees permitted under §§ 235.3 and 234.4. *See* proposed comment 6–1.i.

Proposed comment 6–1.ii clarifies that payments or incentives paid by a payment card network 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 fixed payments for debit card related activities. Payments or incentives paid by a payment card network to an issuer do not include any interchange transaction fees that are passed through to the issuer by the network. Incentives paid by a payment card network also do not include funds received by an issuer from a payment card network as a result of chargebacks or violations of network rules or requirements by a third party. The proposed comment further clarifies that fees paid by an issuer to a payment card network include, but are not limited to, network processing, or switch, fees paid for each transaction, as well as fees charged to issuers that are not particular to a transaction, such as membership or licensing fees and network administration fees. Fees paid by an issuer could also include fees for optional services provided by the network.

Proposed comment 6–2 provides examples of circumstances that do not evade or circumvent the interchange transaction fee restrictions. In the first proposed 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 year. However, because of the additional debit card activity, the aggregate switch fees paid by the issuer to the network also increase. Assuming 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, no circumvention or evasion of the interchange transaction fee restrictions has occurred. *See* proposed comment 6–2.i.

In the second example, an issuer receives a rate reduction for network processing fees due to an increase in debit card transactions during a calendar year that reduces the total amount of network processing fees paid by the issuer during the year. However, the total amount of all fees paid to the network by the issuer continues to exceed the total amount of incentive payments received by the issuer from the network. Under these circumstances, the issuer does not circumvent or evade the interchange

transaction fee restrictions. *See* proposed comment 6–2.ii.

Proposed comment 6–3 clarifies that the prohibition in § 235.6 against circumventing or evading the interchange transaction fee restrictions 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.

Comment is requested regarding how the rule should address signing bonuses that a network may provide to attract new issuers or to retain existing issuers upon the execution of a new agreement between the network and the issuer. Such bonuses arguably do not circumvent or evade the interchange transaction fee restrictions because they do not serve to compensate issuers for electronic debit transactions that have been processed over the network. Moreover, if such payments were considered in assessing whether network-provided incentives during a calendar year impermissibly exceeded the fees paid by an issuer during that year, it could constrain a network's ability to grow the network and achieve greater network efficiencies by potentially removing a significant tool for attracting new issuers. However, if such signing bonuses are not taken into account in determining whether an issuer receives net compensation for electronic debit transactions, a network could provide significant upfront incentive payments during the first year of a contract or space out incentive payments over several years to offset the limitations on interchange transaction fees that could be received by the issuer over the course of the contract.

The Board also requests comment on all aspects of the proposed prohibition against circumvention or evasion, including whether the rule should provide any additional examples to illustrate the prohibition against circumvention or evasion of the interchange transaction fee restrictions.

VII. Sec. 235.7 Limitations on Payment Card Restrictions

EFTA Section 920(b) sets forth provisions limiting the ability of issuers and payment card networks to restrict merchants and other persons from establishing the terms and conditions under which they may accept payment cards. For example, EFTA Section 920(b) prohibits an issuer or payment card network from establishing rules that prevent merchants from offering discounts based on the method of payment tendered. In addition, the statute prohibits an issuer or payment card network from establishing rules preventing merchants from setting minimum and maximum transaction amounts for accepting credit cards. These two statutory provisions are self-executing and are not subject to the Board's rulemaking authority.[89]

However, the Board is directed to prescribe implementing regulations with respect to two additional limitations set forth in the statute. First, the Board must issue rules prohibiting an issuer or payment card network from restricting the number of payment card networks on which an electronic debit transaction may be processed (network exclusivity restrictions).[90] Second, the Board must issue rules 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).[91] Proposed § 235.7 implements these additional limitations on payment card network restrictions.

The statutory exemptions for small issuers, government-administered payment cards, and certain reloadable prepaid cards under EFTA Section 920 apply only to the restrictions on interchange transaction fees in EFTA Section 920(a). *See* proposed § 235.5, discussed above. Thus, these exemptions do not apply to the limitations on payment card network restrictions under EFTA Section 920(b), including the prohibitions on network exclusivity arrangements and merchant routing restrictions implemented in proposed § 235.7. *See* proposed comment 7–1.

A. Sec. 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 restricting, through any agent, processor, or licensed member of a payment card network, the number of payment card networks on which an electronic debit transaction may be processed to fewer than two unaffiliated payment card networks. Proposed § 235.7(a) implements the new requirement.

In recent years, payment card networks have increasingly offered issuers financial incentives in exchange for committing a substantial portion of their debit card transaction volume to the network. For example, some issuers may agree to shift some or all of their debit card transaction volume to the 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. In many cases, issuers have agreed to make the payment card network, or affiliated networks, the exclusive network(s) associated with the issuer's debit cards. For example, some issuers have agreed to restrict their cards' signature debit functionality to a single signature debit network and PIN debit functionality to the PIN debit network that is affiliated with the signature debit network. Certain signature debit network rules also prohibit issuers of debit cards carrying the signature network brand from offering other signature debit networks or certain competing PIN debit networks on the same card. *See* proposed comments 7(a)–1 and –2 describing the terms PIN and signature debit.

Some issuers also negotiate or enroll in "exclusivity arrangements" with payment card networks for other business purposes. For example, an issuer may want to shift a substantial portion or all of its debit card volume to a particular network to reduce core processing costs through economies of scale; to control fraud and enhance data security by limiting the points for potential compromise; or to eliminate or reduce the membership and compliance costs associated with connecting to multiple networks.

From the merchant perspective, the availability of multiple card networks on a debit card is attractive because it gives merchants the flexibility to route transactions over the network that will result in the lowest cost to the merchant. This flexibility may promote direct price competition among the debit card networks that are enabled on the debit card. Thus, debit card network exclusivity arrangements limit merchants' ability to route transactions over lower-cost networks and may reduce price competition.

From the cardholder perspective, however, requiring multiple payment card 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 carried over a specific card network. Similarly, insurance benefits for certain types of transactions or purchases or the

[89] 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).

[90] *See* EFTA Section 920(b)(1)(A).

[91] *See* EFTA Section 920(b)(1)(B).

ability to receive text alerts regarding possible fraudulent activity may be tied to the use of a specific network.[92] Requiring multiple unaffiliated payment card networks, coupled with a merchant's ability to route electronic debit transactions over any of the networks, could reduce the ability of a cardholder to control, and perhaps even to know, over which network 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 explain to the cardholders that they will receive certain benefits only if a merchant chooses to route their transaction over that particular network.

In the proposed rule, the Board requests 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, for example, by 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 two unaffiliated payment card networks available for processing an electronic debit transaction for each method of authorization 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.

Alternative A

EFTA Section 920(b)(1)(A) 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 less than two unaffiliated payment card networks. Nothing in EFTA Section 920(b)(1)(A) specifically requires that there must be two unaffiliated payment card networks available to the merchant once the method of debit card authorization has been determined. 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.

In addition, requiring multiple unaffiliated payment card networks on a debit card for each method of card authorization could potentially limit the development and innovation of new authorization methods. Although PIN and signature are the primary methods of debit card transaction authorization today, new authentication measures involving biometrics or other technologies may, in the future, be more effective in reducing fraud. However, an issuer may be unable to implement these new methods of card authorization if the rule requires that such transactions be capable of being processed on multiple unaffiliated networks. Moreover, the Board understands that enabling the ability to process a debit card transaction over multiple signature debit networks may not be feasible in the near term. Specifically, enabling multiple signature debit networks on a debit card could require the replacement or reprogramming of millions of merchant terminals as well as substantial changes to software and hardware for networks, issuers, acquirers, and processors in order to build the necessary systems capability to support multiple signature debit networks for a particular debit card transaction.

Finally, the Board recognizes that small debit card issuers could be disproportionately affected by a requirement to have multiple networks for each method of debit card authorization. *See* proposed comment 7(a)–7, discussed below. Alternative A would minimize the overall compliance costs for these issuers.

For these reasons, Alternative A would provide that the network exclusivity prohibition could be satisfied as long as an electronic debit transaction may be processed on at least two unaffiliated payment card networks. *See* § 235.7(a)(1) (Alternative A). Proposed comment 7(a)–3 under Alternative A clarifies that Alternative A does not require an issuer to have multiple, unaffiliated networks available for each method of cardholder authorization. Under Alternative A, 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.

Alternative B

The Board also recognizes that the effectiveness of the rule promoting network competition could be limited in some circumstances if an issuer can satisfy the requirement simply by having one payment card network for signature debit transactions and a second unaffiliated payment card network for PIN debit transactions. In particular, the Board understands that only about 2 million of the 8 million merchant locations in the United States that accept debit cards have the capability to accept PIN debit transactions. Thus, in those locations that accept only signature debit, potentially under Alternative A only a single payment card network would be available to process electronic debit transactions.

In addition, PIN debit functionality generally is not available in certain merchant categories or for certain types of transactions. For example, the Board understands that PIN debit typically cannot be used for hotel stays or car rentals for which a merchant obtains an authorization for an estimated transaction amount, but the actual transaction amount is not known until later, when the cardholder checks out of the hotel or returns the rental car. Because PIN debit transactions are single-message transactions that combine the authorization and clearing instructions, the Board understands that it is currently not feasible to use PIN debit in circumstances where the final transaction amount differs from the authorized transaction amount. PIN debit is also not currently available for Internet purchase transactions in most cases. Thus, for these transaction types, the unavailability of PIN debit as an alternative method of authorization effectively means that only a single card network would be available to process an electronic debit transaction if Alternative A is adopted in the final rule.

Finally, the Board notes that Alternative A could limit the effectiveness of the separate prohibition on merchant routing restrictions under new EFTA Section 920(b)(1)(B), discussed below, if an issuer elected to enable only one signature debit network and one unaffiliated PIN network on a particular debit card. This is because once the cardholder has authorized the

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

transaction using either a signature or PIN entry, the merchant would have only a single network available for routing the transaction.

Under Alternative B, an issuer or payment card network would be prohibited from directly or indirectly restricting the number of payment card networks on which an electronic debit transaction may be processed to less than two unaffiliated networks "for each method of authorization that may be used by the cardholder." This means that an issuer would not comply with the proposed rule for a signature and PIN-enabled debit card unless there were at least two unaffiliated signature debit networks and at least two unaffiliated PIN debit networks enabled on the card.

Proposed comment 7(a)–3 under Alternative B clarifies that under this alternative, each electronic debit transaction, regardless of the method of authorization, must be able to be processed on at least two unaffiliated payment card networks. For example, if a cardholder authorizes an electronic debit transaction using a signature, that transaction must be capable of being processed on at least two unaffiliated signature-based payment card networks. Similarly, if a cardholder authorizes an electronic debit transaction using a PIN, that transaction must be capable of being processed on at least two unaffiliated PIN-based payment card networks. This comment would also clarify that the use of contactless or radio-frequency identification (RFID) technology would not constitute a separate method of authorization as the Board understands that such transactions are generally processed over either a signature debit network or a PIN debit network.

The Board requests comment on both proposed alternatives for implementing the prohibition on network exclusivity arrangements under EFTA Section 920(b)(1)(A). Comment is requested on the cost and benefits of each alternative, including for issuers, merchants, cardholders, and the payments system overall. In particular, the Board requests comment on the cost of requiring multiple payment card networks for signature-based debit card transactions, and the time frame necessary to implement such a requirement.

Proposed § 235.7(a)(2) describes 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.

First, proposed § 235.7(a)(2)(i) addresses payment card networks that operate in a limited geographic acceptance area. Specifically, the proposed rule provides that adding an unaffiliated payment card network that is not accepted throughout the United States would not satisfy the requirement to have at least two unaffiliated payment card networks enabled on a debit card. 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. However, an issuer would be in compliance 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. Proposed comment 7(a)–4.i provides an example to illustrate the provision regarding limited geographic acceptance networks. The proposed comment also clarifies that a payment card network is considered to have sufficient geographic reach even though there may be limited areas in the United States that it does not serve. For example, a national network that has no merchant acceptance in Guam or American Samoa may nonetheless meet the geographic reach requirement.

The Board requests comment on the impact of the proposed approach to networks with limited geographic acceptance on the viability of regional payment card networks, and whether other approaches may be appropriate, including, but not limited to, requiring that a particular debit card be accepted on at least two unaffiliated payment card networks (under either alternative) in States where cardholders generally use the card. If the Board permitted a regional network by itself to satisfy the requirement, what standard should be used for determining whether that network provides sufficient coverage for the issuer's cardholders' transactions? The Board also requests comment on the potential impact, and particularly the cost impact, on small issuers from adding multiple payment card networks in order to ensure that a debit card is accepted on a nationwide basis on at least two unaffiliated payment card networks.

Second, proposed § 235.7(a)(2)(ii) provides that adding an unaffiliated payment card network that is accepted only at a limited number of merchant locations or for limited merchant types or transaction 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 only accepted 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. The Board requests comment on whether additional guidance regarding networks that have limited merchant acceptance is necessary.

Third, the proposed rule would prohibit 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. *See* proposed § 235.7(a)(2)(iii). Proposed comment 7(a)–5 provides examples of prohibited restrictions on an issuer's ability to contract with other payment card networks. For example, a payment card network would be prohibited from limiting or otherwise restricting, by rule, contract, or otherwise, the other payment card networks that may be enabled on a particular debit card, such as by expressly prohibiting an issuer from offering certain specified payment card networks on the debit card or by limiting the payment card networks that may be offered on a card to specified networks. *See* proposed comment 7(a)–5.i.

Proposed § 235.7(a)(2)(iii) 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 number or location of network brands, marks, or logos that may appear on the debit card. *See* proposed comment 7(a)–5.ii. Such rules or guidelines may 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.

Proposed comment 7(a)–6 provides, however, that nothing in the rule requires that a debit card identify the brand, mark, or logo of each payment card network over which an electronic debit transaction may be processed. For example, a debit card that operates on two or more different unaffiliated payment card networks need not 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).

Proposed § 235.7(a) does not expressly prohibit debit card issuers from committing to a certain volume, percentage share, or dollar amount of transactions to be processed over a particular network. However, these volume, percentage share, or dollar amount commitments 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. As discussed below under proposed § 235.7(b), these issuer or payment card network routing priorities would be prohibited by the proposed limitations on merchant routing restrictions. The Board requests comment on whether it is necessary to address volume, percentage share, or dollar amount requirements in the exclusivity provisions, and whether other types of arrangements should be addressed under the rule.

Proposed comment 7(a)–7 clarifies that the requirements of § 235.7(a) apply equally to voluntary arrangements in which a debit card issuer participates exclusively in a single payment card network or affiliated group of payment card networks by choice, rather than due to a specific network rule or contractual commitment. For example, although an issuer may prefer to offer a single payment card network (or the network's affiliates) on its debit cards to reduce its processing costs or for operational simplicity, the statute's exclusivity provisions do not allow that. Thus, the proposed comment clarifies that all issuers must issue cards enabled with at least two unaffiliated payment card networks, even if the issuer is not subject to any rule of, or contract, arrangement, or any 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.

Proposed comment 7(a)–8 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 proposed comment under Alternative A 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. The Board is also proposing a corresponding comment that would apply to Alternative B.

Proposed § 235.7(a)(3) addresses 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 proposed rule requires issuers in these circumstances to add an additional unaffiliated debit card network no later than 90 days after the date on which the prior unaffiliated payment card networks become affiliated. The Board requests comment on whether 90 days provides sufficient time for issuers to negotiate new agreements and add connectivity with the additional networks in order to comply with the rule.

Additional Requests for Comment

The Board understands that some institutions may wish to issue a card, or other payment code or device, that meets the proposed definition of "debit card," but that may be capable of being processed using only a single authorization method. For example, a key fob or mobile phone embedded with a contactless chip may be able to be processed only as a signature debit transaction or only on certain networks. 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 requests comment on whether this could inhibit the development of these devices in the future and what steps, if any, the Board should take to avoid any such impediments to innovation.

As noted above under proposed comment 7–1, the statutory exemptions for small issuers, government-administered payment cards, and certain reloadable prepaid cards do not apply to the limitations on payment card network restrictions under EFTA Section 920(b). Thus, for example, government-administered payment cards and reloadable prepaid cards, including health care and other employee benefit cards, would be subject to the prohibition on the use of exclusive networks under EFTA Section 920(b)(1). The Board understands that in many cases, issuers do not permit PIN functionality on prepaid cards in order to prevent cash access in response to potential money laundering or other regulatory concerns. In addition, in the case of debit cards issued in connection with health flexible spending accounts and health reimbursement accounts, Internal Revenue Service (IRS) rules require the use of certain sophisticated technology at the point-of-sale to ensure that the eligibility of a medical expense claim can be substantiated at the time of the transaction. However, PIN-debit networks may not currently offer the functionality or capability to support the required technology. Thus, 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 do not add the necessary functionality to comply with those regulations. The Board requests comment on any alternatives, consistent with EFTA Section 920, that could minimize the impact of the proposed requirements on these prepaid products.

B. Sec. 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 that 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 proposing to implement this restriction in § 235.7(b). Specifically, proposed § 235.7(b) would prohibit 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.

In practice, this means that merchants, not issuers or networks, must be able to designate preferences for the routing of transactions, and that the merchant's preference must take priority over the issuer's or network's preference. The rules of certain PIN debit payment card networks today require merchants to route PIN debit transactions based on the card issuer's designated preferences. This is the case even where 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 there are multiple PIN networks available.[93] 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. Neither of these practices would be permitted under the proposed rule.

The Board does 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 interprets 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. Moreover, allowing merchants to route transactions over any network, regardless of the networks enabled on the debit card, would render superfluous the requirement to have at least two unaffiliated payment cards enabled on a particular debit card. Accordingly, proposed comment 7(b)–1 clarifies 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.

Proposed comment 7(b)–2 provides 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). Although routing generally refers to sending the transaction information to the issuer, the Board notes that the statute broadly directs the Board to prescribe the rules that prohibit issuer or payment card network practices that "inhibit" a person's ability to direct the routing of the transaction. Accordingly, the Board believes it is appropriate also to address certain practices that may affect the network choices available to the merchant at the time the transaction is processed.

The first example addresses 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 authorization. For example, merchants may want to encourage cardholders to authorize a debit card transaction by entering their PIN, rather than by providing a signature, if PIN debit carries a lower interchange rate than signature debit. Under proposed § 235.7(b) and comment 7(b)–2.i, merchants may not be inhibited from encouraging the use of PIN debit by, for example, setting PIN debit as a default payment method or blocking the use of signature debit altogether.

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* proposed comment 7(b)–2.ii. Thus, for example, if multiple networks are 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. Nothing in proposed 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, proposed 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. *See, e.g.,* Iowa Code Sec. 527.5.

As noted above, if issuer- or network-directed priorities are prohibited, issuers will, as a practical matter, be unable to guarantee or otherwise agree to commit a specified volume, percentage share, or dollar amount of debit card transactions to a particular debit card network. Accordingly, the Board believes it is unnecessary to separately address volume, percentage share, or dollar amount commitments of debit card transactions as prohibited forms of network exclusivity arrangements under proposed § 235.7(a).

Under the third example, a payment card network could not require a particular method of debit card authorization based on the type of access device provided by the cardholder. *See* proposed 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 may only be processed over a signature debit network. The Board requests comment on whether there are other circumstances that the commentary should include as examples of prohibited routing restrictions.

Although proposed § 235.7 provides merchants control over how an electronic debit transaction is routed to the issuer, the proposed rule does not impose a requirement that a merchant be able to select the payment card network over which to route or direct a particular electronic debit transaction in real time, that is, at the time of the transaction. The Board believes that requiring real-time merchant routing decision-making could be operationally infeasible and cost-prohibitive in the short term as it would require systematic programming changes and equipment upgrades. Today, for example, transaction routing is relatively straightforward once the cardholder has chosen to authorize a debit card transaction using his or her PIN. Once the PIN is entered, card information for the transaction is transmitted to the merchant's acquirer or processor and the transaction is then generally routed over a pre-determined network based upon issuer or payment network routing priorities for that card. Under proposed § 235.7(b), however, issuer and network routing priorities would no longer be permitted, except under limited circumstances. *See* proposed comment 7(b)–2.ii, discussed above. Instead, merchants would be free to make the routing decision. Although merchant-directed routing tables administered by the acquirer or processor could be somewhat more complex than issuer-directed routing tables given the larger number of merchants, such a system could still be administered in the straightforward manner they are administered today with the routing decisions determined in advance for a particular merchant. Accordingly, proposed comment 7(b)–3 provides that it is 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 on behalf of the merchant.

C. Effective Date

Although EFTA Section 920 requires that the restrictions on the amount of interchange transaction fees become effective on July 21, 2011, the statute does not specify an effective date for the separate provisions on network exclusivity and merchant routing restrictions. As discussed above, the new provisions provide that at least two unaffiliated payment card networks must be available for processing any electronic debit transaction, and prohibit issuers and payment card

[93] 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.

networks from inhibiting merchants from directing how electronic debit transactions may be routed based upon the available choices. In order to implement these new requirements, certain system changes will be required. For example, before a debit card may be enabled for an additional payment card network, connectivity will have to be established with the new network and internal processing systems upgraded to support that network. In some cases, new cards may have to be issued to cardholders. Acquirers and processors will have to be notified of the new network assignments for each debit card program and their routing tables updated for each issuer and card program. Payment card networks will have to ensure that they have sufficient processing capacity to support any necessary changes.

If Alternative B is adopted in the final rule and multiple signature debit networks are required for each debit card, the Board anticipates that significantly more time will be needed to enable issuers and networks to comply with the rule. The Board requests 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, or alternatively, an effective date of January 1, 2013 if Alternative B were adopted in the final rule.

The Board requests comment on all aspects of implementing the proposed limitations on network exclusivity and merchant routing restrictions under § 235.7, including the specific changes that will be required and the entities affected. The Board also requests comment on other, less burdensome alternatives that may be available to carry out the proposed restrictions under § 235.7 to reduce the necessary cost and implementation time period.

Sec. 235.8 Reporting Requirements

Section 920 authorizes the Board to collect from issuers and payment card networks information that is necessary to carry out the provisions of this section and requires the Board to publish, if appropriate, summary information about costs and interchange transaction fees every two years. Summary information from information collections conducted prior to this proposed rulemaking is discussed above. The Board anticipates using forms derived from the Interchange Transaction Fee Surveys (FR 3062; OMB No. 7100), but with a narrower scope, for purposes of these proposed reporting requirements.[94] At this time, however, the Board is not publishing specific forms for comment. The Board does not anticipate requiring the first report to be submitted before March 31, 2012. Prior to that time, the Board will provide an opportunity for comment on the specific reporting forms and reporting burden. The Board, however, is seeking comment on the reporting requirements as laid out generally in proposed § 235.8.

Consistent with the statutory information collection authority, the Board proposes to require issuers that are subject to §§ 235.3 and 235.4 and payment card networks to submit reports to the Board. Each entity required to submit a report would submit the form prescribed by the Board. The forms would request information regarding costs incurred with respect to electronic debit transactions, interchange transaction fees, network fees, and fraud-prevention costs. Similar to the surveys conducted in connection with this proposed rulemaking, the Board may publish summary or aggregate information.

The Board proposes that each entity would be required to report biennially, consistent with the Board's statutory publication requirement. The Board anticipates that circumstances may develop that require more frequent reporting. Accordingly, under proposed § 235.8(c), the Board reserves the discretion to require more frequent reporting.

For the years an entity is required to report, the Board proposes that such entity must submit the report to the Board by March 31 of that year. The Board believes that permitting three months following the end of the calendar-year reporting period provides a reasonable time to determine the costs that need to be reported and complete the report. The Board is requesting comment on whether the three-month time frame is appropriate.

Proposed § 235.8(e) would require entities that are required to report under this section to retain records of reports submitted to the Board for five years. Further, such entities would be required to make each report available upon request to the Board or the entity's primary supervisors. The Board believes that the record retention requirement will facilitate administrative enforcement.

[94] Copies of the survey forms are available on the Board's Web site at *http://www.federalreserve.gov/newsevents/reform_meetings.htm.*

Sec. 235.9 Administrative Enforcement

The interchange transaction fee requirements and the network exclusivity and routing rules are enforced under EFTA Section 918 (15 U.S.C. 1693o), which sets forth the administrative agencies that enforce the requirements of the EFTA. Unlike other provisions in the EFTA, the requirements of Section 920 are not subject to EFTA Section 916 (civil liability) and Section 917 (criminal liability). Further, the Dodd-Frank Act amends the current administrative enforcement provision of the EFTA. Therefore, proposed § 235.9 sets forth the administrative enforcement agencies under EFTA Section 918 as amended by the Dodd-Frank Act.

Form of Comment Letters

Comment letters should refer to Docket No. R–1404 and, when possible, should use a standard typeface with a font size of 10 or 12; this will enable the Board to convert text submitted in paper form to machine-readable form through electronic scanning, and will facilitate automated retrieval of comments for review. Comments may be mailed electronically to *regs.comments@federalreserve.gov.*

Solicitation of Comments Regarding Use of "Plain Language"

Section 772 of the Gramm-Leach-Bliley Act of 1999 (12 U.S.C. 4809) requires the Board to use "plain language" in all proposed and final rules published after January 1, 2000. The Board invites comment on whether the proposed rule is clearly stated and effectively organized, and how the Board might make the text of the rule easier to understand.

Paperwork Reduction Act

In accordance with the Paperwork Reduction Act (PRA) of 1995 (44 U.S.C. 3506; 5 CFR part 1320 Appendix A.1), the Board reviewed this proposed rule under the authority delegated to the Board by the Office of Management and Budget. The Board will conduct an analysis under the Paperwork Reduction Act and seek public comment when it develops surveys to obtain information under § 235.8. Any additional burden associated with the reporting requirement in proposed § 235.3(d) (under Alternative 1) for issuers that wish to receive an interchange fee in excess of the safe harbor is considered negligible. Thus no new collections of information pursuant to the PRA are contained in the proposed rule.

Regulatory Flexibility Act

In accordance with Section 3(a) of the Regulatory Flexibility Act, 5 U.S.C. 601 *et. seq.* (RFA), the Board is publishing an initial regulatory flexibility analysis for the proposed new Regulation II (Debit Card Interchange Fees and Routing). The RFA requires an agency to provide an initial regulatory flexibility analysis with the proposed rule or to certify that the proposed rule will not have a significant economic impact on a substantial number of small entities. The Board welcomes comment on all aspects of the initial regulatory flexibility analysis. A final regulatory flexibility analysis will be conducted after consideration of comments received during the public comment period.

1. *Statement of the objectives of the proposal.* As required by Section 920 of the EFTA (15 U.S.C. 1693r), the Board is proposing new Regulation II to establish standards for assessing whether an interchange transaction fee received or charged by an issuer (and charged to the merchant or acquirer) is reasonable and proportional to the cost incurred by the issuer with respect to the transaction. Additionally, proposed 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 and inhibiting the ability of a merchant to direct the routing of an electronic debit transaction over a particular payment card network.

2. *Small entities affected by the proposal.* This proposal may have an effect predominantly on two types of small entities—financial institutions that either issue debit cards or acquire transactions from merchants and the merchants themselves. A financial institution generally is considered small if it has assets of $175 million or less.[95] Based on 2010 Call Report data, approximately 11,000 depository institutions had total domestic assets of $175 million or less. Of this number, however, it is unknown how many of these institutions issue debit cards. Whether a merchant is a small entity is determined by the asset size or the number of employees.[96] Of the 8 million merchant locations that accept debit cards, the number of merchants that are considered small entities is unknown.

3. *Compliance requirements.* With respect to the limitations on interchange transaction fees, the Board's proposed rule does not affect most such entities directly.[97] In accordance with Section 920 of the EFTA, the Board's proposed 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 proposed rule does not require payment card networks to distinguish between issuers with assets of more than $10 billion and smaller issuers. If a payment card network decides to distinguish between large and small issuers, a payment card network may require a smaller issuer to submit information to it. The proposed rule, however, does not impose reporting requirements on smaller issuers. As discussed in other sections of the preamble, the proposed interchange transaction fee standards are expected to reduce the amount of interchange transaction fees charged to merchants and acquirers. Accordingly, the Board expects any economic impact on small merchants and acquirers to be positive.

The proposed rule prohibiting network exclusivity arrangements may affect small financial institutions that issue debit cards if such institutions do not currently comply with the Board's proposed standards. Under one alternative, a small issuer, like other issuers, would be required to have at least two unaffiliated payment card networks on each debit card it issues. If the issuer does not do so already, it would be required to add an additional network. This process may require making a decision as to which additional network to put on a card, establishing a connection to the new network, or updating internal processes and procedures. Under the second alternative, a small issuer, like all issuers, would be required to issue debit cards with at least two unaffiliated networks for each method of authorization a cardholder could select. The actions that may be necessary to add additional networks under the second alternative are the same as those under the first alternative. An issuer, however, would incur greater costs as the number of networks it adds increases. In contrast, like all merchants that accept debit cards, smaller merchants will be provided with greater routing choice. Therefore, the smaller merchants will be able to route electronic debit transactions over the lowest-cost path. Accordingly, the Board expects any economic impact on merchants to be positive.

4. *Other Federal rules.* The Board believes that no Federal rules duplicate, overlap, or conflict with proposed Regulation II.

5. *Significant alternatives to the proposed rule.* As discussed above, the Board has requested comment on the impact of the network exclusivity and routing alternatives (the provisions of the proposal that apply to small issuers) on small entities and has solicited comment on any approaches, other than the proposed alternatives, that would reduce the burden on all entities, including small issuers. The Board welcomes comment on any significant alternatives that would minimize the impact of the proposal on small entities.

List of Subjects in 12 CFR Part 235

Electronic debit transactions, interchange transaction fees, and debit card routing.

Authority and Issuance

For the reasons set forth in the preamble, the Board is proposing to add new 12 CFR 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 transaction fees.
235.4 [Reserved]
235.5 Exemptions.
235.6 Prohibition on circumvention or evasion.
235.7 Limitations on payment card restrictions.
235.8 Reporting requirements.
235.9 Administrative enforcement.

Appendix A—Official Board Commentary on Regulation II

Authority: 15 U.S.C. 1693r.

§ 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. 1693r, as added by section 1075 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 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, exemptions from the interchange transaction fee limitations, prohibitions on evasion and circumvention,

[95] 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.*

[96] *Id.*

[97] There may be some small financial institutions that have very large affiliates such that the institution does not qualify for the small issuer exemption.

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* 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.

(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 an institution 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.

(3) The term "debit card" 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;

(ii) A check, draft, or similar paper instrument, or an electronic representation thereof; or

(iii) An account number, when used to initiate an ACH transaction to debit a person's account.

(g) *Designated automated teller machine (ATM) network* means either—

(1) All automated teller machines identified in the name of the issuer; or

(2) Any network of automated teller machines identified by the issuer that provides reasonable and convenient access to the issuer's customers.

(h) *Electronic debit transaction* means the use of a debit card by a person as a form of payment in the United States.

(i) *General-use prepaid card* means a card, or other payment code or device, that is—

(1) Issued on a prepaid basis, 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, or usable at automated teller machines.

(j) *Interchange transaction fee* means 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.

(k) *Issuer* means any person that issues a debit card.

(l) *Merchant* means any person that accepts debit cards as payment for goods or services.

(m) *Payment card network* means an entity that—

(1) Directly or indirectly provides the services, infrastructure, and software for 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.

(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) *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.

Alternative 1 (Issuer-Specific Standard With Safe Harbor and Cap):

(b) *Determination of reasonable and proportional fees.* Except as provided in paragraph (e) of this section, an issuer complies with the requirements of paragraph (a) of this section only if, during an implementation period of October 1 of any calendar year through September 30 of the following calendar year, each interchange transaction fee it receives or charges is no more than the greater of—

(1) Seven cents per transaction; or

(2) The costs described in paragraph (c) of this section incurred by the issuer with respect to electronic debit transactions during the calendar year preceding the start of the implementation period, divided by the number of electronic debit transactions on which the issuer charged or received an interchange transaction fee during that calendar year, but no higher than twelve cents per transaction.

(c) *Allowable costs.* For purposes of paragraph (b) of this section, the costs incurred by an issuer for electronic debit transactions—

(1) Are only those costs that vary with the number of transactions sent to the issuer and that are attributable to—

(i) Receiving and processing requests for authorization of electronic debit transactions;

(ii) Receiving and processing presentments and representments of electronic debit transactions;

(iii) Initiating, receiving, and processing chargebacks, adjustments, and similar transactions with respect to electronic debit transactions; and

(iv) Transmitting or receiving funds for interbank settlement of electronic debit transactions; and posting electronic debit transactions to cardholder accounts; and

(2) Do not include fees charged by a payment card network with respect to an electronic debit transaction.

(d) *Disclosure to payment card network.* If, during an implementation period of October 1 of any given calendar year through September 30 of the following calendar year, an issuer subject to this section will receive or charge an interchange transaction fee in excess of seven cents per transaction under paragraph (b)(2) of this section, the issuer must report, by March 31 of the same calendar year as the start of the implementation period, to each payment card network through which its electronic debit transactions may be routed the amount of any interchange transaction fee it may receive or charge under paragraph (b)(2).

(e) *Transition.* From July 21, 2011 through September 30, 2012, an issuer complies with the requirements of paragraph (a) of this section if any

interchange transaction fee it receives or charges is no more than the greater of—

(1) Seven cents per transaction; or

(2) The costs described in subsection (c) of this section incurred by the issuer for electronic debit transactions during the 2009 calendar year, divided by the number of electronic debit transactions on which the issuer received or charged an interchange transaction fee during the 2009 calendar year, but no higher than twelve cents per transaction.

Alternative 2 (Cap):

(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 twelve cents per transaction.

§ 235.4 [Reserved]

§ 235.5 Exemptions.

(a) *Exemption for small issuers.* Sections 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 issuer holds the account that is debited; and

(2) The issuer, together with its affiliates, has assets of less than $10 billion as of the end of the previous 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 if the electronic debit transaction is made 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); and

(ii) Reloadable and not marketed or labeled as a gift card or gift certificate.

(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 charged for transferring funds from another asset account to cover a shortfall in the account accessed by the card; or

(2) A fee charged 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.

§ 235.6 Prohibition on circumvention or evasion.

(a) *Prohibition on circumvention or evasion.* No person shall circumvent or evade the interchange transaction fee restrictions in §§ 235.3 and 235.4. Circumvention or evasion of the interchange fee restrictions under §§ 235.3 and 235.4 occurs if an issuer receives net compensation from a payment card network with respect to electronic debit transactions.

§ 235.7 Limitations on payment card restrictions.

(a) *Prohibition on network exclusivity.* (1) *In general.*

Alternative A: 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.

Alternative B: 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 for each method of authorization that may be used by the cardholder.

(2) *Prohibited exclusivity arrangements.* For purposes of paragraph (a)(1) of this section, an issuer or payment card network does not satisfy the requirement to have at least two unaffiliated payment card networks on which an electronic debit transaction may be processed if—

(i) The unaffiliated network(s) that is added to satisfy the requirements of this paragraph does not operate throughout the United States, unless the debit card is accepted on a nationwide basis on at least two unaffiliated payment card networks when the network(s) with limited geographic acceptance is combined with one or more other unaffiliated payment card networks that also accept the card.

(ii) The unaffiliated network(s) that is added to satisfy the requirements of this paragraph is accepted only at a small number of merchant locations or at limited types of merchants; or

(iii) The payment card network restricts or otherwise limits 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.

(3) *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 this paragraph (a), 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 90 days after the date on which the prior unaffiliated payment card networks become affiliated.

(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.

§ 235.8 Reporting requirements.

(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 is not limited to, data regarding costs incurred with respect to an electronic debit transaction, interchange transaction fees, network fees, fraud-prevention and data-security costs, and fraud losses.

(c) *Timing.* (1) Each entity shall submit the data in a form prescribed by the Board biennially.

(2) Each entity shall submit the report to the Board by March 31 of the year the entity is required to report.

(3) The first report shall be submitted to the Board by March 31, 2012.

(d) *Disclosure.* The Board may, in its discretion, disclose aggregate or summary information reported under this section.

§ 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 U.S.C. 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 U.S.C. 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 U.S.C. 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 U.S.C. 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 U.S.C. 1813(s)) shall have the meaning given to them in section 1(b) of the International Banking Act of 1978 (12 U.S.C. 3101).

(b) *Additional powers.* (1) For the purpose of the exercise by any agency referred to in paragraphs (a)(1)(i) through (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 (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 (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.

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.

Sec. 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 a business-purpose debit card. 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. The term "account" also includes bona fide trust arrangements.

2. *Account located in the United States.* This part applies only to electronic debit transactions that are initiated to debit (or credit 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 at a bank 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 the network. These institutions are not "acquirers" because they do not provide credit for transactions or settle to the merchant's transactions with the merchant. These institutions that only process or route transactions are considered processors for purposes of this part (*See* § 235.2(o) and commentary thereto).

2(c) Affiliate

1. *Types of entities.* The term "affiliate" includes both bank and nonbank affiliates.

2. *Other affiliates.* For commentary on whether merchants are affiliated, see comment 2(f)–5.

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" is the 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 underlying funds. *See,* however, § 235.2(f)(3)(iii). Similarly, the term "debit card" includes a device with a chip or other embedded mechanism that links the device to funds stored in an account, such as a mobile phone or sticker containing a contactless chip that enables an account to be debited.

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 are held and made unavailable for other transactions for a specified period of time. After the expiration of the applicable 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 chosen by the issuer, 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. Deferred debit card arrangements do not refer to arrangements in which a merchant defers presentment of multiple small-dollar card payments, but aggregates those payments into a single transaction for presentment, or where a merchant requests placement of a hold on funds in an account until the actual amount of the cardholder's transaction is known and submitted for settlement.

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 via a subsequent ACH debit to that account. Because the term "debit card" applies to any card, or other payment code or device, that is issued or approved for use through a payment card network to debit an account, regardless of whether the issuer holds the account, decoupled debit cards are debit cards for purposes of this subpart.

4. *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.

5. *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, the Board would view franchisees 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.

6. *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.

7. *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 the 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 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 automated teller machine network includes any network of automated teller machines identified by the issuer that provides reasonable and convenient access to the issuer's cardholders. An issuer provides reasonable and convenient access, for example, if, for each person to whom a card is issued, the network provides access to an automated teller machine in the network within the metropolitan statistical area of the person's last known address, or if the address is not known, where the card was first issued.

2(h) Electronic Debit Transaction

1. *Subsequent transactions.* The term "electronic debit transaction" includes both the cardholder's use of a debit card for the initial purchase of goods or services and any subsequent use by the cardholder of the debit card in connection with the initial purchase of goods or services. For example, the term "electronic debit transaction" includes using the debit card to return merchandise or cancel a service that then results in a credit to the account initially debited to pay for the merchandise or service.

2. *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 purchase goods or services and to withdraw cash (known as a "cashback transaction").

3. *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 at a U.S. bank or a U.S. branch of a foreign bank, 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 card, or other payment code or other device, is redeemable upon presentation at multiple, unaffiliated merchants if such merchants agree to honor the card, or other payment code or device, if, for example, it bears the mark, logo, or brand of a payment card network, pursuant to the rules of the payment network.

2. *Mall cards.* Mall cards that are generally intended to be used or redeemed for goods or services at participating retailers within a shopping mall are considered general-use prepaid cards if they carry the mark, logo, or brand of a payment card network and can be used at any retailer that accepts that card brand, including retailers located outside of the mall.

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 merchants or acquirers. The merchants or acquirers then pay to the issuers any interchange transaction fee established and charged by the network. Therefore, issuers are considered to receive interchange transaction fees from merchants or acquirers.

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 transaction. (*See* § 235.3(c) and commentary thereto for a description of an issuer's role in the transaction). In contrast, a payment card network may charge issuers and acquirers fees for sending transaction information to the network for clearing and settlement. Such fees are not interchange transaction fees because the payment card network is charging and receiving the fee as compensation for its role in clearing and settling.

2(k) Issuer

1. *In general.* The term "issuer" means any person that issues a debit card. 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. *Four-party systems.* In a four-party system, the cardholder receives the card directly or indirectly (*e.g.,* through the bank's agent) from the account holding bank and has a direct contractual relationship with its bank with respect to the card. In this system, the cardholder's bank is the issuer.

3. *Three-party systems.* In a three-party system, the network typically provides the card, either directly or indirectly, to the cardholder and holds the cardholder's account. Accordingly, the network is also the issuer with respect to the card. In most cases, the network also has a contractual relationship with the cardholder.

4. *BIN-sponsor arrangements.* Payment card networks assign member-financial

institutions Bank Identification Numbers (BINs) 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 take 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 provide, directly or indirectly, debit cards to its account holders. The bank or credit union's name typically will appear on the debit card. The bank or credit union also holds the underlying account that is debited and has the primary relationship with the cardholder. Under these circumstances, the bank or credit union is the issuer for purposes of this part. If that affiliate member, 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 issues cards through the BIN sponsors, the BIN sponsor does not have the direct relationship with the cardholder, and therefore 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, the BIN-sponsoring institution generally holds the funds for the prepaid card program in a pooled account, although 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 cardholder's relationship is generally with the bank holding the funds in the pooled account. This bank typically is also the BIN sponsor. Accordingly, under these circumstances, the BIN sponsor, or the bank holding the pooled account, is the issuer.

5. *Decoupled debit cards.* In the case of decoupled debit cards, an entity other than the entity holding the cardholder's account directly or indirectly provides the debit card to the cardholder and has a direct relationship with the cardholder. The account-holding institution does not have a relationship with the cardholder with respect to the decoupled debit card. Under these circumstances, the entity providing the debit card, and not the account-holding institution, is considered the issuer. If the issuer of a decoupled debit card, together with its affiliates, has assets of less than $10 billion, the issuer is not exempt under § 235.5(a) because it is not the entity holding the account to be debited.

2(l) Merchant [Reserved]

2(m) Payment Card Network

1. *Scope of definition.* The term "payment card network" generally includes only those entities that establish guidelines, rules, or procedures that govern the rights and obligations of, at a minimum, issuers and acquirers involved in processing electronic debit transactions through the network. Such guidelines, rules, or procedures may also govern the rights and obligations of merchants, processors, or cardholders in addition to issuers and acquirers. The term "payment card network" includes an entity that serves in the multiple roles of payment card network and issuer and/or acquirer, such as in the case of a three-party system, to the extent that the entity's guidelines, rules, or procedures also cover its activities in its role(s) as issuer or acquirer. Acquirers, issuers, third-party processors, payment gateways, or other entities that may provide services, equipment, or software that may be used in authorizing, clearing, or settling electronic debit transactions are generally excluded from the term "payment card network," unless such entities also establish guidelines, rules, or procedures that govern the rights and obligations of issuers and acquirers involved in processing an electronic debit transaction through the network. For example, an acquirer is not considered to be a payment card network solely due to the fact that it establishes particular transaction format standards, rules, or guidelines that apply to electronic debit transactions submitted by merchants using the acquirer's services, because such standards, rules, or guidelines apply only to merchants that use its services, and not to other entities that are involved in processing those transactions, such as the card issuer.

2(n) Person [Reserved]

2(o) Processor

1. *Distinction from acquirers.* Although a processor may perform all transaction-processing functions for a merchant or acquirer, a processor is not the entity that acquires (that is, settles with the merchant for) the transactions. The entity that acquires 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.* An issuer may use a third party to perform services related to authorization, clearance, and settlement of transactions. The third party is the issuer's processor.

2(p) United States [Reserved]

Sec. 235.3 Reasonable and Proportional Interchange Transaction Fees

Alternative 1 (Issuer-Specific Standard With Safe Harbor and Cap):

3(a) [Reserved]

3(b) Determination of Reasonable and Proportional Fees

1. *Two options.* An issuer may comply with § 235.3(a) in two ways: (1) an issuer may elect to receive or charge an interchange transaction fee that is no more than the amount in § 235.3(b)(1), known as the "safe harbor," or (2) an issuer may determine the maximum interchange transaction fee it may receive or charge using the cost-based approach in § 235.3(b)(2) (*See* § 235.3(c) and related commentary). An issuer complies with § 235.3(a) if it receives an interchange transaction fee in an amount at or below the safe harbor even if the maximum interchange transaction fee that the issuer is able to receive or charge under § 235.3(b)(2) is less than the safe harbor.

2. *Safe harbor.* An issuer that receives or charges interchange fees at or below the amount in § 235.3(b)(1) (known as the "safe harbor") is not required to compute an interchange fee transaction amount under § 235.3(b)(2). An issuer that receives or charges an interchange transaction fee in an amount at or below the safe harbor, however, must comply the reporting requirements in § 235.8.

3. *Cap.* An issuer that determines the maximum interchange transaction fee that it may receive or charge under the cost-based approach in § 235.3(b)(2) may not receive or charge an interchange transaction fee above the maximum amount allowable under § 235.3(b)(2), known as the "cap," even if its costs are above the cap. In contrast, if an issuer calculates that it has allowable per-transaction costs that are lower than the cap, that issuer may not receive or charge an interchange transaction fee higher than the amount determined using the formula in § 235.3(b)(2) or the safe harbor amount, whichever is greater.

4. *Variation among interchange fees.* A network is permitted to set fees that vary with the value of the transaction (*ad valorem* fees), as long as the maximum amount of the interchange fee received by an issuer for any electronic debit transaction was not more than that issuer's maximum permissible interchange fee. A network is permitted to establish different interchange fees for different types of transactions (e.g., card-present and card-not-present) or different types of merchants, as long as each of those fees satisfied the relevant limits of the standard.

3(c) Issuer Costs

1. *In general.* Section 235.3(c) sets forth the allowable costs that an issuer may include when calculating its interchange transaction fee under § 235.3(b)(2). These costs are those that are attributable to the authorization, clearance, and settlement of electronic debit transactions. Section 235.3(c)(1) further limits the costs in §§ 235.3(c)(1)(i) through (c)(1)(iv) to those that vary with the number of transactions sent to the issuer.

2. *Activities.* Section 235.3(c)(1) limits the allowable costs that an issuer may include when calculating its interchange transaction fee to the variable costs associated with its role in authorization, clearance, and settlement of electronic debit transactions.

i. *Issuer's role in authorization.* Section 235.3(c)(1)(i) describes an issuer's role in the authorization process. The authorization process begins when the cardholder presents a debit card or otherwise provides the card information to the merchant to purchase goods or services and ends when the merchant receives notice that the issuer either has approved or denied the transaction. In both four-party and three-party systems, the issuer receives the request for authorization of the electronic debit transaction. In a four-party system, the approval request is sent to the issuer via the acquirer and payment card network (and any

processors that the acquirer or issuer may use). In a three-party system, the payment card network is both the issuer and the acquirer and therefore the approval request travels through fewer parties. In both systems, the issuer decides whether to approve or deny the electronic debit transaction based on several factors, such as the availability of funds in the cardholder's account. Once the issuer approves or denies the transaction, it sends the approval or denial back through the payment card network and acquirer (and any processors) to the merchant. Section 235.3(c)(1)(i)'s authorization activities include activities such as data processing, voice authorization inquiries, and referral inquiries. An issuer generally performs separate activities with the primary purpose of fraud-prevention in connection with authorization. Those separate activities are not considered to be part of an issuer's role in authorization under § 235.3(c)(1).

ii. *Issuer's role in clearance.* Section 235.3(c)(1)(ii) describes the issuer's role in the clearance process. Clearance is the process of submitting a record of an electronic debit transaction for payment. In PIN debit (or single-message) networks, the authorization message also generally serves as the clearance of the transaction. In signature debit (or dual-message) networks, the acquirer sends the clearance message through the network to the issuer following the completion of the purchase by the cardholder, as specified in payment card network rules. Section 235.3(c)(1)(ii)'s signature-debit clearance activities include activities such as data processing and reconciling clearing message information.

iii. *Non-routine transactions.* In some instances, an issuer may decide to reverse settlement for an electronic debit transaction, pursuant to payment card network rules. This reversal is known as a "chargeback." The issuer's role in the clearance process includes the process of initiating the chargeback. After the acquirer receives a chargeback, the acquirer may decide to represent the transaction, pursuant to the network rules. The issuer's role in the clearance process also includes receiving and processing representments. Finally, after the initial clearance process, an acquirer may determine that the transaction record contained an error. For example, the transaction record may reflect an incorrect transaction amount or may be a duplicate of a previous transaction. The issuer's role in the clearance of a transaction also includes receiving and processing adjustments. Accordingly, § 235.3(c)(1)(iii)'s non-routine clearance activities include activities such as data processing to prepare and send the chargeback message through the network, and reconciliation expenses specific to receiving representments and error adjustments, such as posting a credit to a cardholder's account. An issuer's clearance costs do not include the costs of receiving cardholder inquiries about particular transactions.

iv. *Issuer's role in settlement.* Issuers have two roles in settlement of electronic debit transactions: Interbank settlement and settlement with the cardholders. Interbank settlement is the process of transferring funds between issuers and acquirers. Typically, each day a payment card network will collect all transactions sent for clearing and will determine the net amount owed by each issuer and acquirer, after deducting interchange transaction fees and other fees. The issuer (unless it is also a large merchant acquirer) will generally be in a net debit position and will transmit funds for interbank settlement. Issuers settle the electronic debit transactions with their cardholders by posting the transactions to the cardholder accounts. Section 235.3(c)(1)(iv)'s settlement costs include the fees for settlement through a net settlement service, ACH, or Fedwire®, and data processing costs for posting transactions to the cardholders' accounts.

3. *Issuer's costs.*

i. *Variable costs vs. fixed costs.* Variable costs that are attributable to authorizing, clearing, and settling electronic debit transactions can be considered in determining an issuer's permissible interchange transaction fee. For example, the portion of an issuer's data-processing costs that vary based on the number of authorization requests is a variable cost. If an issuer uses a third-party processor or other agent for all of its authorization, clearance, and settlement activities, then any per-transaction fee the third-party processor charges is a variable cost for the issuer. In contrast, fixed costs are those costs that do not vary with changes in output up to existing capacity limits within a calendar year. For example, an issuer may pay a fixed fee to connect to a network in order to process transactions. The connectivity fee is a fixed cost.

ii. *Network fees excluded.* Per-transaction fees (*e.g.,* switch fees) paid to the network in its role as network for purposes of authorization, clearance, and settlement are not an allowable cost. A payment card network may offer optional authorization, clearance, and settlement services to an issuer. In this case, although the network is charging fees to the issuer, the network is not doing so in its role as a network. Rather, these fees are considered fees an issuer pays to a processor. Therefore, fees charged by a network for its role as a third-party processor may be included in an issuer's allowable costs, provided they otherwise are permissible to include under § 235.3(c)(1).

iii. *Common costs excluded.* Common costs, which are not attributable to authorization, clearance, and settlement, are not allowable costs. For example, an issuer may not allocate a portion of its overhead costs (*e.g.,* the costs of its facilities or its human resources and legal staff) for the purpose of calculating its permissible interchange transaction fee. Similarly, the costs of operating a branch office are common to all banking activities, including the debit card program, and therefore are not allowable costs.

iv. *Costs of other activities excluded.* Section 235.3(c) sets forth an exclusive list of costs that an issuer may include when determining the amount of an interchange transaction fee it may receive or charge with respect to an electronic debit transaction. Therefore, an issuer may not include those costs that are not incurred for the activities listed in §§ 235.3(c)(1)(i) through (iv). In addition, as discussed earlier, fixed costs, even if incurred for activities related to authorization, clearance, or settlement of debit card transactions, may not be included. Fraud losses, the cost of fraud-prevention activities, and the cost of rewards programs are not includable as allowable costs.

3(d) Disclosure to payment card network

1. *No differentiation.* A payment card network may, but is not required to, differentiate among issuers subject to § 235.3 when setting interchange transaction fees. If a payment card network chooses to set the interchange transaction fee for all issuers that are subject to the interchange fee standards at or below the safe harbor amount, it is not necessary for issuers to report to the payment card network through which it receives electronic debit transactions the maximum amount of any interchange transaction fee it may receive or charge.

2. *Differentiation.* If a payment card network differentiates among issuers when setting interchange transaction fees, any issuer that is subject to the interchange fee standards receives or charges interchange transaction fees above the safe harbor must report the maximum amount of any interchange transaction fee it may receive or charge to the payment card network. An issuer must report such amount by March 31 of each calendar year for which it will be receiving an interchange transaction fee above the safe harbor (effective October 1 of the calendar year). An issuer need not submit its detailed cost information to the payment card networks.

Alternative 2 (Cap):

3(a) [Reserved]

3(b) Determining reasonable and proportional fees

1. *Variation among interchange fees.* A network is permitted to set fees that vary with the value of the transaction (*ad valorem* fees), as long as the maximum amount of the interchange fee received by an issuer for any electronic debit transaction was not more than that issuer's maximum permissible interchange fee. A network is permitted to establish different interchange fees for different types of transactions (*e.g.,* card-present and card-not-present) or types of merchants, as long as each of those fees satisfied the relevant limits of the standard.

Sec. 235.4 [Reserved]

Sec. 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 previous calendar year. In this case, the 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.

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, are less than $10 billion.

5(b) Exemption for government-administered payment programs

1. *Government-administered payment program.* Electronic debit transactions made using a debit card issued pursuant to a government-administered payment program generally are exempt from the interchange fee restrictions. 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. 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.

5(c) Exemption for certain reloadable prepaid cards

1. *Reloadable.* Electronic debit transactions made using certain reloadable general-use prepaid cards are exempt from the interchange fee restrictions. 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 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.

2. *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.)

3. *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.

4. *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 same facts as in comment 5(c)–4.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 same facts as in comment 5(c)–4.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 same facts as in comment 5(c)–4.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.

5. *On-line sales of prepaid cards.* 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.

6. *Temporary non-reloadable cards issued in connection with a general-purpose 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 card holder 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 as long as the card is not marketed as a gift card or gift certificate.

Sec. 235.6 Prohibition on Circumvention or Evasion

1. *Illustration of circumvention or evasion.* A finding of evasion or circumvention will depend on all relevant facts and circumstances.

i. *Example.* Circumvention or evasion of the interchange transaction fee restrictions is indicated in the following example: The total amount of payments or incentives received by an issuer from a payment card network during a calendar year in connection with electronic debit transactions, other than interchange transaction fees passed through to the issuer by the network, exceeds the total amount of all fees paid by the issuer to the network for electronic debit transactions during that year.

ii. *Incentives or fees considered.* 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 fixed payments for debit card related activities. Incentives or payments made by a payment card network do not include interchange transaction fees that are passed through to the issuer by the network. In addition, funds received by an issuer from a payment card network as a result of chargebacks or violations of network rules or requirements by a third party do not constitute incentives or payments made by a payment card network. Fees paid by an issuer to a payment card network include, but are not limited to network processing, or switch fees, membership or licensing fees, network administration fees, and fees for optional services provided by the network.

2. *Examples of circumstances not involving circumvention or evasion.* The following examples illustrate circumstances that would not indicate circumvention or evasion of the interchange transaction fee restrictions in §§ 235.3 and 235.4:

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 year. Over the same period, however, the total network 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 payments or incentives paid by the network to the issuer. Under these circumstances, the issuer does not receive any net compensation from the network for electronic debit transactions, and thus, no circumvention or evasion of the interchange transaction fee restrictions has occurred.

ii. Because of an increase in debit card transactions that are processed through a payment card network during a calendar year, an issuer receives a rate reduction for network processing fees that reduces the total amount of network processing fees paid by the issuer during the year. However, the total amount of all fees paid to the network by the issuer for debit card transactions continues to exceed the total amount of payments or incentives received by the issuer from the network for such transactions. Under these circumstances, the issuer does not receive any net compensation from the network for electronic debit transactions and thus, no circumvention or evasion of the interchange transaction fee restrictions has occurred.

3. *No applicability to exempt issuers or electronic debit transactions.* The prohibition against circumventing or evading the interchange transaction fee restrictions does not apply to issuers or electronic debit transactions that qualify for an exemption under § 235.5 from the interchange transaction fee restrictions.

Sec. 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, an issuer of debit cards for government-administered payment programs, while exempt from the restrictions on interchange transaction fees, is 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 determine the routing for electronic debit transactions.

7(a) Prohibition on Network Exclusivity

1. *Personal Identification Number (PIN) debit.* The term "PIN debit" refers to a cardholder's use of a personal identification number, or PIN, to authorize a debit card transaction. Payment card networks that process debit card transactions that are typically authorized by means of a cardholder's entry of a PIN are referred to as "PIN" or "PIN-based" (or single message) debit networks.

2. *Signature debit.* The term "signature debit" generally refers to a cardholder's use of a signature to authorize a debit card transaction. Payment card networks that process debit card transactions that are typically authorized by means of a cardholder's signature are referred to as "signature" or "signature-based" debit (or dual message) networks.

Alternative A (Two unaffiliated networks)

3. *Scope of restriction.* Section 235.7(a) does not require an issuer to have multiple, unaffiliated networks available for each method of cardholder authorization. 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.

Alternative B (Two unaffiliated networks for each authorization method)

3. *Scope of restriction.* Section 235.7(a) provides that each electronic debit transaction, regardless of the method of authorization used by the cardholder, must be able to be processed on at least two unaffiliated payment card networks. For example, if a cardholder authorizes an electronic debit transaction using a signature, that transaction must be capable of being processed on at least two unaffiliated signature-based payment card networks. Similarly, if a consumer authorizes an

electronic debit transaction using a PIN, that transaction must be capable of being processed on at least two unaffiliated PIN-based payment card networks. The use of alternative technologies, such as contactless or radio-frequency identification (RFID), to authorize a transaction does not constitute a separate method of authorization because such transactions are generally processed over either a signature debit network or a PIN debit network.

4. *Examples of limited geographic or merchant acceptance networks.* Section 235.7(a) requires that a payment card network (or combination of payment card networks) meet geographic and merchant acceptance requirements to satisfy the rule. The following are examples of payment card networks that would not meet the geographic or merchant acceptance tests:

i. A payment card network that operates in only a limited region of the United States would not meet the geographic test, unless one or more other unaffiliated payment card network(s) are also enabled on the card, such that the combined geographic coverage of networks permits the card to be accepted on at least two unaffiliated payment card networks for any geographic area in the United States. For example, an issuer may not issue a debit card that is enabled solely on one payment card network that is accepted nationwide and another unaffiliated payment card network that operates only in the Midwest United States. In such case, the issuer would also be required to add one or more unaffiliated payment card networks that would generally enable transactions involving the card to be processed on at least two unaffiliated payment card networks in almost all of the rest of the country. A payment card network is considered to have sufficient geographic reach even though there may be limited areas in the United States that it does not serve. For example, a national network that has no merchant acceptance in Guam or American Samoa would nonetheless meet the geographic reach requirement.

ii. A payment card network that is accepted only at a limited category of merchants (for example, at a particular grocery store chain or at merchants located in a particular shopping mall).

5. *Examples of prohibited 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.

ii. Network rules or guidelines that allow only that network's brand, mark, or logo to be displayed on a particular debit card or that otherwise limit the number, or location, of network brands, marks, or logos that may appear on the debit card.

6. *Network logos or symbols on card not required.* Section 235.7(a) does not require that a debit card identify the brand, mark, or logo of each payment card network over which an electronic debit transaction may be processed. For example, a debit card that is enabled for two or more unaffiliated payment card networks need not bear the logos or symbols for each card network.

7. *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 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.

Alternative A Only (Two unaffiliated networks)

8. *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 in 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.

Alternative B Only (Two unaffiliated networks for each authorization method)

8. *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 for a particular debit card, as long as, for each method of authorization, 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 network for PIN debit transactions as long as those debit cards may also be accepted on a second signature debit network and a second PIN debit network, both of which are unaffiliated with the first network.

7(b) Prohibition on Routing Restrictions

1. *Relationship to the network exclusivity restrictions.* The prohibition on routing restrictions applies solely to the payment card networks on which an electronic debit transaction may be processed for a particular debit card. Thus, an issuer or payment card network is prohibited from inhibiting a merchant's ability to route or direct the transaction over any of the payment card networks that the issuer has enabled to process an electronic debit transaction for that particular 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, 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 method of debit card authorization based on the type of access device provided by to the cardholder by the issuer, such as requiring the use of signature debit if the consumer provides a contactless debit card.

3. *Real-time routing decision not required.* Section 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. Instead, the merchant and its acquirer may agree to a pre-determined set of routing choices that apply to all electronic debit transactions that are processed by the acquirer on behalf of the merchant.

By order of the Board of Governors of the Federal Reserve System, December 16, 2010.

Jennifer J. Johnson,

Secretary of the Board.

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