BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: September 21, 2022

To: Board of Governors

From: Staff[1]

Subject: Final Amendments to Regulation II to Clarify the Prohibition on Network Exclusivity

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Action Requested

Staff requests approval to publish the attached draft *Federal Register* notice and draft final rule, which amends Regulation II (Debit Card Interchange Fees and Routing) and the Official Board Commentary on Regulation II.[2] The final rule underscores that debit card issuers should provide routing choice for card-not-present (for example, online) debit card transactions and is substantively similar to the proposal, while also clarifying that an issuer is not required to ensure that two unaffiliated networks will actually be available to the merchant for every transaction.

Summary

As required by the Dodd-Frank Act, a provision of Regulation II known as the "prohibition on network exclusivity" prohibits debit card issuers and payment card networks from restricting the number of networks on which a debit card transaction may be processed to fewer than two unaffiliated networks.[3] This prohibition aims to promote competition among networks by ensuring that merchants have an opportunity to choose between at least two unaffiliated networks when routing debit card transactions.

When the Board issued Regulation II in 2011, the market had not yet developed solutions to broadly support multiple networks for card-not-present debit card transactions, such as online purchases. In the ensuing decade, most networks have introduced the technical capabilities to

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[1] Mark Manuszak, Ian Spear, Krzysztof Wozniak, Elena Falcettoni, and Larkin Turman (RBOPS); Evan Winerman, Jess Cheng, and Cody Gaffney (Legal).
[2] Staff requests the authority to make technical, non-substantive changes to the *Federal Register* notice and final rule prior to publication.
[3] 12 C.F.R. part 235.7(a).

process card-not-present debit card transactions. In parallel, spurred by the growth in e-commerce, card-not-present transactions have become an increasingly significant portion of all debit card transactions. Despite these developments, data collected by the Board and information from debit card industry participants indicate that some issuers are not enabling two unaffiliated networks to process card-not-present transactions performed with their debit cards, although it appears the majority of community banks already do so. In those cases where only one network is enabled for card-not-present transactions, merchants do not have an alternative network option that might offer lower fees or better fraud-prevention capabilities.

To address this issue, in May 2021, the Board invited public comment on a proposal that would amend Regulation II and the Official Board Commentary on Regulation II to (i) specify that the prohibition on network exclusivity applies to card-not-present debit card transactions, (ii) clarify the responsibility of the issuer in enabling at least two unaffiliated networks to comply with the prohibition on network exclusivity, and (iii) standardize and clarify the use of certain terminology. The Board received more than 2,750 comments in response to the proposal.

The attached final rule is substantively consistent with the proposal, while also addressing issues raised by commenters. The final rule underscores that issuers should provide routing choice for card-not-present debit card transactions. Like the proposal, the final rule specifies that card-not-present transactions are a particular type of debit card transaction for which issuers must enable at least two unaffiliated networks. Compared with the proposal, the final rule includes certain changes that make it easier for issuers to determine whether they are compliant with the prohibition on network exclusivity. In addition, to address an overly broad reading of the proposal raised by some commenters, which the Board did not intend, the final rule adds language to emphasize that Regulation II does not require an issuer to ensure that two unaffiliated networks will actually be available to the merchant to process every transaction. Lastly, the final rule adopts most of the proposal's revisions to standardize and clarify the use of certain terminology.

The final rule does not affect other parts of Regulation II that directly address interchange fees for certain debit card transactions. This limit to the scope of the revisions is explicitly noted in the attached *Federal Register* notice and was similarly noted at the proposal stage. The notice further states that the Board will continue to review the regulation in light of the most recent data collected by the Board and may propose additional revisions in the future.

Background on Regulation II

The Dodd-Frank Act directs the Board to regulate interchange transaction fees for debit card transactions and establish rules for payment card transactions.[4] Among other things, the statute requires the Board to prohibit issuers and networks from restricting the number of networks over which a debit card transaction may be processed to fewer than two unaffiliated networks.[5] This requirement is intended to promote competition among networks by ensuring that merchants have an opportunity to choose between at least two unaffiliated networks when routing debit card transactions.

The Board implemented this requirement when it adopted Regulation II in July 2011.[6] Specifically, Regulation II's prohibition on network exclusivity provides that an issuer must allow a debit card transaction to be processed on at least two unaffiliated networks, each of which does not, by rule or policy, restrict the operation of the network to a limited geographic area, specific merchant, or particular type of merchant or transaction.[7]

Summary of Issue, Proposal, and Comments Received

When the Board issued Regulation II in 2011, the debit card industry had not yet developed solutions to broadly support multiple networks over which merchants could route card-not-present debit card transactions.[8] At the time, many networks could not process such transactions at all, while others could do so only with technology that was not widely deployed

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[4] Specifically, section 1075 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-230, amended the Electronic Fund Transfer Act, 15 U.S.C. 1693 *et seq.*, to add a new section 920 regarding interchange transaction fees for debit card transactions and rules for debit card and credit card transactions. EFTA section 920 is codified at 15 U.S.C. 1693o-2.

[5] EFTA section 920(b)(1)(A). A debit card transaction typically involves at least five parties: (i) a cardholder, (ii) the entity that issued the debit card to the cardholder (the issuer), (iii) a merchant, (iv) the merchant's depository institution (the acquirer), and (v) a network. The issuer provides the cardholder with a debit card and enables various networks to process debit card transactions performed with such card. The cardholder can perform a debit card transaction at a merchant that accepts at least one of the enabled networks. If the merchant accepts more than one of the enabled networks, the merchant (or its acquirer) can choose to route the transaction over the merchant's preferred network.

[6] Regulation II also implements a separate provision of EFTA section 920 regarding debit card interchange fees. The final rule does not concern these interchange fee provisions.

[7] The regulation additionally requires that each such network must have taken steps reasonably designed to enable the network to process the debit card transactions that the network would reasonably expect will be routed to it, based on expected transaction volume.

[8] *See* Federal Reserve Board, *2011 Interchange Fee Revenue, Covered Issuer Costs, and Covered Issuer and Merchant Fraud Losses Related to Debit Card Transactions* (Mar. 5, 2013) at p. 11, available at https://www.federalreserve.gov/paymentsystems/files/debitfees_costs_2011.pdf.

in the marketplace.[9] In the ensuing decade, however, most networks have introduced the technical capabilities to process card-not-present transactions.[10] In parallel, card-not-present debit card transactions have become an increasingly significant portion of all debit card transactions, rising from about 10 percent of all debit card transactions by volume in 2011 to 23 percent in 2019.

Despite these developments, data collected by the Board and information from debit card industry participants indicate that some issuers are not enabling two unaffiliated networks to process card-not-present transactions performed with their debit cards. As a result, merchants often do not have the opportunity to choose from at least two unaffiliated networks when routing card-not-present transactions.[11] Instead, merchants often have no alternative but to route card-not-present transactions over the only network that the issuer has enabled to process card-not-present transactions performed with its debit cards.[12]

To address this issue, on May 13, 2021, the Board published a proposal to amend Regulation II.[13] First, the Board proposed revisions to specify that the prohibition on network exclusivity applies to card-not-present debit card transactions. Second, the Board proposed further revisions to clarify the responsibility of the issuer in enabling at least two unaffiliated networks to comply with the prohibition on network exclusivity. Finally, in addition to these

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[9] In particular, the lack of widely-deployed methods for online entry of personal identification numbers (PINs) was an impediment for single-message networks that traditionally required PIN entry during transaction authorization. Issuers typically enable one or more single-message networks and one dual-message network to process debit card transactions performed with the issuer's debit card. Single-message networks, which developed from automated teller machine (ATM) networks, typically authorize and clear a transaction through a single message and have traditionally processed transactions that are authenticated using a cardholder's PIN. In contrast, dual-message networks, which developed from credit card systems, typically authorize and clear a transaction through two separate messages and have traditionally processed signature-authenticated transactions. In general, the interchange fees that issuers receive in connection with transactions routed over single-message networks are lower than for transactions routed over dual-message networks. *See* Average Debit Card Interchange Fee by Payment Card Network, available at https://www.federalreserve.gov/paymentsystems/regii-average-interchange-fee.htm.

[10] *See* Federal Reserve Board, *2019 Interchange Fee Revenue, Covered Issuer Costs, and Covered Issuer and Merchant Fraud Losses Related to Debit Card Transactions* (May 2021) at p. 3, available at https://www.federalreserve.gov/paymentsystems/files/debitfees_costs_2019.pdf.

[11] For example, according to the Board's most recent biennial data collection, in 2019, almost a quarter of issuers with consolidated assets over $10 billion, representing slightly more than 50 percent of all debit card transactions subject to Regulation II's interchange fee standards, processed all card-not-present debit card transactions over a single network enabled on their cards, indicating that those issuers enable only one network for that type of transaction.

[12] In these cases, the sole network enabled to process card-not-present debit card transactions is generally a dual-message network.

[13] 86 FR 26189 (May 13, 2021). The original proposal requested public comment by July 12, 2021. The Board later extended the comment period an additional 30 days to August 11, 2021. 86 FR 34644 (June 30, 2021).

substantive changes, the Board proposed non-substantive changes unrelated to the issue of card-not-present routing to standardize and clarify the use of certain terminology.[14]

The Board received more than 2,750 comment letters in response to the proposal. Approximately 2,600 of the comment letters were one of 11 form letters. Approximately 1,700 were from debit card issuers (all of whom were depository institutions) and related trade associations, approximately 1,000 were from merchants and related trade associations, 5 were from networks, 3 were from federal agencies, 3 were from government officials, and around 40 were from other interested parties (including some consumers and consumer groups).

Commenters supporting the proposal generally expressed the view that the proposal is consistent with the intent of the statute and would appropriately clarify requirements that already apply to issuers. These commenters further argued that it would increase routing choice for debit card transactions and promote competition between networks, thereby reducing costs for merchants and ultimately prices for consumers. These commenters generally included merchants, single-message networks, and federal agencies.

Commenters opposing the proposal generally expressed the view that the proposal goes beyond mere clarification of existing requirements and would impose new obligations and significant compliance costs on issuers. Some of these commenters urged the Board to withdraw the proposal. Commenters opposing the proposal generally included issuers and dual-message networks.

Amendments to Regulation II in the Final Rule

Staff recommends that the Board adopt the attached final rule, which underscores that issuers should provide routing choice for card-not-present debit card transactions and is substantively consistent with the proposal while also addressing issues raised by commenters. Under the final rule, an issuer must configure each of its debit cards so that card-not-present transactions performed with those cards can be processed on at least two unaffiliated networks.[15]

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[14] For example, the Board proposed to replace the informal use of "network" with the defined term "payment card network" throughout the commentary to section 235.7.

[15] Under the final rule, section 235.7(a)(2) of Regulation II will provide that an issuer satisfies the prohibition on network exclusivity only if the issuer enables at least two unaffiliated networks to process an electronic debit transaction, where such networks satisfy two requirements. First, the enabled networks in combination must not, by their respective rules or policies, or by contract with or other restriction imposed by the issuer, result in the operation of only one network or only multiple affiliated networks for a geographic area, specific merchant, particular type of

As a practical matter, an issuer will first need to determine whether card-not-present transactions performed with its debit cards can already be processed on at least two unaffiliated networks. If the issuer is not already compliant with the final rule, then the issuer will need to adjust its debit card processing arrangements to meet the final rule's requirements.

Compared with the proposal, the final rule includes certain changes that make it easier for issuers to determine whether they are already compliant with the prohibition on network exclusivity. Specifically, the final rule retains the approach in current Regulation II that allows issuers to rely on network rules or policies in determining whether the networks enabled by an issuer may be used to satisfy the prohibition on network exclusivity. In addition, the final rule adds language to emphasize that, contrary to the broad reading of the proposal put forward by many commenters, the prohibition on network exclusivity does not require an issuer to ensure that two or more unaffiliated networks will actually be available to the merchant to process every debit card transaction. Finally, based on comments received, the final rule adopts most, but not all, of the proposed revisions to the commentary to standardize and clarify the use of certain terminology.[16]

The final rule becomes effective in just over nine months on July 1, 2023. Staff believes that nine months, which is the same amount of time that issuers were given to comply with the prohibition on network exclusivity when Regulation II was promulgated in 2011, is a sufficient amount of time for issuers of all sizes that do not already have two unaffiliated networks enabled for card-not-present transactions to comply with the final rule.[17] Importantly, several comment letters received in connection with the proposal suggest that many issuers, and especially most community bank issuers, are already compliant with the final rule's requirements.

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merchant, or particular type of transaction. Second, as in the current rule, the enabled networks must have each taken steps reasonably designed to be able to process the electronic debit transactions that they would reasonably expect will be routed to them, based on expected transaction volume.

[16] For example, the final rule does not adopt the changes in current comment 235.7(a)-7 as proposed, which would have provided that the prohibition on network exclusivity regardless of the "means of access." Commenters stated that the undefined term "means of access" would create confusion and would undermine clarity. Instead, the final rule states that the prohibition on network exclusivity applies to debit card transactions performed with any debit card as defined in section 235.2 of Regulation II, regardless of the form of such debit card.

[17] Staff discussions with processors that provide services to debit card issuers have confirmed that nine months should be an adequate amount of time for issuers to enable a second network to process card-not-present transactions.

Effects of the Final Rule

The preamble accompanying the attached final rule contains a statutorily-required analysis of the economic impact of the final rule on different parties in the debit card industry (that is, merchants, issuers, networks, and consumers).[18] The analysis concludes that, like the statute itself, the final rule may impact the various parties in the debit card industry in different ways; in some cases, the effect of the final rule on a specific party will depend on that party's particular circumstances. Key factors that may drive the final rule's effects include the extent to which issuers need to adjust their debit card programs and the associated compliance costs; whether such adjustments lead to merchants routing card-not-present transactions over networks with substantially different fees or fraud levels; the degree to which issuers and merchants adjust prices for consumers in response to changes in costs; and, in the long term, enhanced competition for card-not-present transactions among networks. The analysis suggests the final rule is likely to broadly benefit merchants and single-message networks. The analysis further suggests that the final rule should not affect many issuers, because the majority of community banks are already compliant with the final rule. The final rule will increase costs and decrease revenue for other issuers. The level of increased costs will depend on the costs such issuers must incur to come into compliance with the final rule. The decrease in revenue will depend on the extent to which merchants route card-not-present transactions over networks with different fees and fraud-prevention capabilities. Finally, the analysis concludes that, by encouraging competition between networks for card-not-present debit card transactions, the final rule should incentivize networks to improve their fraud-prevention capabilities and lower their fees.

Attachments

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[18] *See* section IV.A of the preamble (analysis of the economic impact of the final rule generally, as required under EFTA 904(a)). *See also* section IV.C of the preamble (analysis of the economic impact of the final rule on small entities, as required under the Regulatory Flexibility Act).