



February 18, 2011

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

Attention: Docket No. R-1404 and RIN No. 7100 AD63

Dear Ms. Johnson:

This letter is submitted to the Board of Governors of the Federal Reserve System (“Board”) by NETS, Inc. (“NETS”) and on behalf of NETS’ members in response to the proposed rule (“Proposed Rule”) to implement EFTA Section 920, as added by Section 1075 (the “Durbin Amendment”) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”).

NETS is a Nebraska non-profit corporation that operates a regional PIN debit network and provides a full range of electronic funds transfer services to its members. In 2010, NETS routed more than 144 million transactions, and supported over 1,400 ATMs across ten Midwestern states. As a non-profit corporation, NETS is owned by and operated for its 285 member financial institutions.

We are concerned that the Board’s Proposed Rule in general—and the geographic-coverage condition of Proposed Section 235.7(a)(2)(i) in particular—does not properly reflect the intent of Congress. Because we are concerned about the negative impact the Proposed Rule would have on the costs of providing debit card programs and the availability of debit card programs at community banks and credit unions, we urge the Board to consider the following comments.

### **I. Geographic Restrictions**

As a regional network, NETS is very concerned about the Board’s proposed geographic condition to qualify as an unaffiliated network for purposes of the Proposed Rule’s routing restrictions. We believe that blanket disqualification of regional networks is not required by EFTA Section 920 and would propose that the Board instead adopt a rule that acknowledges the important role that regional networks like NETS play for community banks and credit unions.

#### **A. *Geographic Restriction Generally***

Under EFTA Section 920(b)(1)(A), the Board is required to prescribe “regulations providing that an issuer or payment card network shall not directly or through any agent, processor, or licensed member of a payment card network, by contract, requirement, condition,

penalty, or otherwise, restrict the number of payment card networks on which an electronic debit transaction may be processed to— (i) 1 such network; or (ii) 2 or more such networks which are owned, controlled, or otherwise operated by — (I) affiliated persons; or (II) networks affiliated with such issuer.” By its plain language, EFTA Section 920(b)(1)(A) does not require nationwide network coverage to fulfill the statutory requirement.

By eliminating exclusive network arrangements and mandating that issuers’ cards carry multiple, unaffiliated networks, Congress clearly intended to increase network competition. We believe the Proposed Section 235.7(a)(2)(i) restricts arbitrarily and unnecessarily the universe of potential networks—and potential network competition—to a handful of networks with nationwide coverage areas. Specifically, Proposed Section 235.7(a)(2)(i) would preclude numerous regional networks like NETS from qualifying as a network that would enable issuers to satisfy the requirement to have at least two unaffiliated payment card networks on which an electronic debit transaction may be processed. Under the Proposed Rule, a network would be required to operate “throughout the United States,” and “on a nationwide basis.” At this time, we believe only three signature debit networks would satisfy this standard, and while there is no consensus as to the exact number of PIN debit networks that might qualify, our best estimate is that no more than five PIN debit networks would qualify.

NETS does not believe that Congress intended to artificially restrict network competition to the handful of networks that fulfill nationwide network coverage requirements. However, NETS understands the Board’s concern that partnerships with regional networks like NETS could be utilized by certain nationwide networks to circumvent and undermine the intended pro-competitive benefits of the Durbin Amendment’s mandate to provide multiple, unaffiliated network routing options for each debit card. That is why NETS believes that the Board’s concerns are valid for issuers that are located outside of a network’s coverage area.

However, for those issuers located within a regional network’s geographic footprint, such regional networks provides what we—and our members—believe to be the most competitive combination of pricing and service quality available. We believe that any regional, non-profit network like NETS should be permitted to qualify as a network that satisfies the Durbin Amendment’s multiple network routing requirement, regardless of whether Alternative A or Alternative B is adopted ultimately, for the following reasons:

- **Affordability.** NETS provides one of the lowest cost routing solutions available to issuers, acquirers and merchants within our geographic coverage area.
- **Competition.** As a low-cost, non-profit network, NETS provides our members with one of the most competitive routing options within their geographic market areas.
- **Fairness.** An arbitrary exclusion of regional networks from the universe of qualifying issuer routing options is fundamentally unfair and undercuts NETS longstanding competitive position within Nebraska and surrounding states.
- **Congressional Intent.** Exclusion of networks like NETS from the universe of qualifying debit networks undercuts the very purpose behind the Durbin Amendment, which is designed to increase competition among debit networks.

*B. Geographic Restriction's Costs to Small Issuers*

In the Proposed Rule, the Board specifically requested 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.

NETS and its 285 members would be affected adversely if the Board were to adopt the Proposed Rule without changing the geographic condition under Section 235.7(a)(2)(i). Membership fees to financial institutions for adding nationwide PIN debit networks like Visa's Interlink network or MasterCard's Maestro network average \$50 per month. In addition to membership fees, there are network fees, processing fees and report generation fees, among others, that add close to \$0.05 per transaction on average. Costs for adding signature debit processing options to cards would be considerably more expensive. By contrast, a low-cost non-profit regional network like NETS could actually help issuers lower their debit compliance costs.

To date, the vast majority of our members have not added multiple national network routing options to their cards for three reasons – cost, duplication and lack of consumer benefit. First, for issuers with small debit card programs, recovery of such costs through economies of scale is an impossibility. As such, a requirement to add one or more nationwide PIN-debit networks to their NETS' cards would require issuers with very limited card programs and limited scalability to incur significant additional costs. Second, many NETS members already offer cards that feature a second, unaffiliated debit network. These issuers' cards therefore could be compliant with the Board's proposed rule but for the proposed geographic restriction, which would require the addition of a third unaffiliated PIN debit network (i.e., NETS plus two nationwide networks). Finally, customers would derive little if any benefit from having an additional PIN debit network associated with their cards. As noted above, the vast majority of transactions made using NETS cards occur within the NETS coverage area, and NETS is far and away the lowest cost routing option due to our non-profit business model. Therefore, requiring the addition of a third unaffiliated network would impose an additional and unnecessary cost on locally focused issuers, like NETS members.

*C. Changes to Proposed Section 235.7(a)(2)(i)*

The Board has requested 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. For the reasons stated above, NETS and its members believe that such an approach is in the best interest of all regional industry participants—cardholders, merchants, issuers, acquirers and regional networks. To that end, NETS urges the Board to adopt the following amendment to Proposed Section 235.7(a)(2)(i):

(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—

(A) does not operate throughout the United States unless—

(I) the debit card is accepted on a nationwide basis on at least two unaffiliated payment card networks, or

(II) the debit card is accepted on a nationwide basis when network(s) with a limited Geographic Coverage Area(s) are combined with one or more other unaffiliated payment card networks that also accept the card, or

(B) is added to a debit card issued by an issuer located within a network's Geographic Coverage Area and at least 80 percent of transactions made using debit cards carrying the network's brand are processed within the network's Geographic Coverage Area.

For purposes of the proposed revision to Section 235.7(a)(2)(i), the term “Geographic Coverage Area” would be defined under Proposed Section 235.2 as follows:

“Geographic Coverage Area” means the geographic area certified by a network to the Board in accordance with Section 235.7(a)(4) .

For NETS, transaction volumes and concentrations from 2010 are illustrative of how such an exemption would apply. For example, in 2010, NETS routed approximately 144 million transactions, of which 88.36 percent took place within Nebraska alone and significantly more than 90 percent occurred within the NETS regional footprint. This high concentration of transactions and high correlation between the location of NETS issuers and NETS cardholders is common among regional networks, most of which should be able to meet the suggested 80-percent Geographic Coverage Area restriction.

To implement this framework, NETS believes that an initial certification to the Board of each network's Geographic Coverage Area should be required of all networks. Considerable confusion has arisen among community banks, credit unions and other small issuers as to whether the networks they employ to route transactions satisfy the proposed nationwide geographic limitation of Section 235.7(a)(2)(i). NETS believes that an initial certification as to a Geographic Coverage Area should be required by all networks including those that are deemed “nationwide networks” to ensure that issuers are capable of complying with the Durbin Amendment's routing restrictions. For regional networks, changes to a Geographic Coverage Area would be reported annually or within 30 days of any event resulting in a material change to the Geographic Coverage Area (e.g., merger with another network). Specifically, NETS proposes that the Board add a new Section 235.7(a)(4) that reads as follows:

(4) Certification of Geographic Coverage Area. Each network shall certify to the Board its Geographic Coverage Area no later than [insert date three months prior to Section 235.7 effective date]. The Board will report each network certification on its website, and such certification may be relied upon by issuers for purposes of complying with the geographic limitation of Section 235.7(a)(2)(i). A network's certification shall remain in effect until the network amends or terminates its certification. Networks shall certify—

(i) annually to the Board any change to the network's Geographic Coverage Area; and

(ii) in the event of a significant expansion or contraction of the network's Geographic Coverage Area, within 30 days of the event causing such change to the network's Geographic Coverage Area.

NETS believes the obligation to certify a Geographic Coverage Area would impose a minimal burden on networks while enabling low-cost regional networks like NETS to significantly increase the competition in the network marketplace. A national network would not be required to certify its Geographic Coverage Area after their initial certification unless it ceases to offer nationwide network coverage. A regional network would be required to certify its Geographic Coverage Areas as of a specified date (e.g., December 31) if there is any change to its Geographic Coverage Area. Issuers would be allowed to rely on the certification for the full year to determine compliance with Section 235.7(a)(2)(i).

Finally, NETS believes that low-cost regional networks should not be punished for practices that were driven by large national networks, which the proposed geographic restrictions would favor. As documented in the Board's Proposed Rule, interchange fees have been on the rise. Networks historically have set interchange fees, but in recent years, NETS has witnessed an enormous increase in the frequency with which interchange fees were adjusted upward—particularly by networks owned by processors. Such networks raised interchange fees to compete with Visa and MasterCard for market share, which ultimately led Visa and MasterCard to raise their interchange fees as well. This “leap frog” effect resulted in part from large, national networks evasion of competition with low-cost regional networks through requirements that issuers enter into exclusive network relationships. At a time when Congress has seen fit to increase competition among debit networks, it does not make sense for the Board to remove some of these large networks' fiercest competition through an arbitrary and unnecessary geographic restriction.

## **II. Responses to Other Requests for Comment**

*A. No ATM Coverage: NETS believes the Proposed Rule should not cover ATM networks unless and until Congress specifically mandates the Board to do so.*

The Board has requested comment as to whether ATM networks and ATM transactions should be covered by the Proposed Rule and, if so, how the Board should implement the network exclusivity provision. As we noted in our introduction, NETS supports over 1,400 ATMs across ten Midwestern states. The economics of ATM networks differ significantly from those of point-of-sale networks, at which the Durbin Amendment ostensibly was directed. Nothing in the Durbin Amendment nor the Dodd-Frank Act's legislative history indicates that ATM networks were intended to be or should be covered under the Durbin Amendment. Without a clear Congressional mandate to regulate ATM interchange fees, we believe the Board should refrain from imposing artificial price restrictions on the highly competitive ATM network marketplace.

*B. Fee Caps: NETS believes market forces will render a cap unnecessary, but if a cap is imposed, the rule should take into account all incremental costs of issuers.*

We believe that the Federal Reserve's Proposed Rule to implement the Durbin Amendment goes far beyond what is required by the Durbin Amendment. Our chief concern is that the proposal for interchange fees for non-exempt issuers and products does not reflect the "reasonable and proportional costs" incurred by issuers of debit products, as required under the statute. Many financial institutions have actual incremental costs in excess of the proposed 7- or 12-cent caps but would be precluded from recovering any of those costs. We believe that the Durbin Amendment does not support the imposition of a cap with respect to any issuer who can provide clear evidence that its incremental costs exceed 7-12 cents.

More important, strong market forces should obviate the need for any rate cap as issuers compete on price to obtain higher transaction volumes. The limits on routing restrictions imposed by EFTA Section 920(b) will increase competition among all parties in the debit card value chain. Because merchants will control routing decisions, market participants will be forced to collaborate to reduce overall fees. However, because the price cap is untenably low, the fee cap is likely to become the *de facto* price floor for interchange fees. Moreover, far from forcing financial institutions to absorb drastic revenue losses, the proposed fee cap may compel many financial institutions to impose account maintenance fees or increase other accountholder costs. Because the proposed rule would distort the market forces that would otherwise result in a reasonable and proportional outcome, any final rule should not include a fee cap.

Nonetheless, if a cap is deemed necessary for ease of administration, we believe the cap should take into account all issuer costs, including: network fees; the cost of inquiries and disputes; fraud losses and fraud prevention costs; fixed costs, including capital investments; and a reasonable profit. A rule that includes all incremental issuer costs would reflect "reasonable and proportional costs" incurred by issuers in making available debit card access.

*C. Two Interchange Fee Proposals: While Alternative B is preferable for administrative simplicity, Alternative A would be possible to implement. If an Issuer-Specific proposal is adopted, networks should be allowed to develop issuer reporting methods to determine each issuer's permissible interchange rate.*

Excepting the issues we see with the artificially low fee caps discussed above, we believe that each of interchange fee approaches may be feasible given sufficient time to implement necessary processes. Both proposals have merit. Whereas we prefer a straightforward cap (Alternative B) for its administrative simplicity, the Issuer-Specific Standard with Safe Harbor and Cap (Alternative A) would allow for determination of interchange fees on an issuer-specific basis, based on the average "allowable costs" for all of an issuer's debit transactions. If any cap is retained, we believe that the cap should be set at a realistic level and that the simple Alternative B structure would be best. If the cap were eliminated in accordance with our reasoning above, we believe an issuer-specific interchange fee structure would be necessary to implement the rule without a cap.

An issuer-specific interchange standard would not be impossible to implement but would require additional time for implementation. Specifically, a means for communicating the allowable costs of each issuer would need to be developed, network rules would need to be written, coding would be required and coordination with processors and issuers would be necessary. We believe these structures do not need to be mandated by the Board but rather can be developed by networks working in concert with their members and industry partners. NETS believes a period of one year from the date of the final rule would be sufficient for us to establish rules and implement the necessary communication systems but understand that some of the larger networks may require more time to develop compliant systems.

*D. NETS supports network-routing Alternative A.*

The Proposed Rule contains two proposals that would limit issuers' and networks' ability to restrict methods of routing debit transactions. 12 C.F.R. § 235.7(a). Under Alternative A, issuers and networks would be prohibited from restricting processing of any card transaction to fewer than two unaffiliated networks. Under Alternative B, a debit card would be required to have two unaffiliated networks for each authorization method available on the card (e.g., two PIN debit networks if PIN-based debit authorization is available on the card).

NETS supports Alternative A because it allows issuers to comply by offering multiple modes of acceptance or, alternatively, two options for acceptance using the same type of platform type (e.g., two PIN debit networks). However, if the Board adopts Alternative B, NETS urges the Board to clarify that cards featuring a single method of authorization (e.g., PIN debit only) also would be compliant if they include only two unaffiliated networks for the single authorization method (e.g., a card with two unaffiliated debit networks but without any signature debit networks would be deemed compliant). Such an option would comply with EFTA Section 920(b) and would allow greater flexibility in the development of debit card programs, particularly for small local and regional issuers like community banks and credit unions for which the cost of joining a signature network is prohibitive.

*E. The proposed effective dates for the routing restrictions under the Proposed Rule would present major complications for all debit-industry participants.*

Given the complexity of the debit card industry, which includes numerous participants and a variety of interdependent systems, we believe additional time should be afforded for

implementation of either proposed routing alternative. Because either rule could require major changes to network rules, network and processor systems and new investments in network infrastructure, we would suggest for Alternative A, an effective date of March 1, 2013; and for Alternative B, an effective date of March 1, 2015.

*F. Fraud Prevention Adjustment: NETS supports a Non-Prescriptive Approach to the fraud-prevention adjustment.*

The Board's proposal requests comment on two general approaches to the fraud-prevention adjustment framework. One approach focuses on implementation of major innovations that may result in reductions in industry-wide fraud losses (the "Technology-Specific Approach"). The second approach focuses on reasonably necessary steps for maintaining a fraud-prevention program but would not prescribe specific technologies that must be employed (the "Non-Prescriptive Approach").

NETS supports adoption of a Non-Prescriptive Approach. The Durbin Amendment specifically states that regulations establishing eligibility for the fraud adjustment shall "require 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" (emphasis added). Technology is but one component of what the Durbin Amendment envisions as reimbursable fraud-prevention services.

Financial institutions that have implemented fraud-detection programs should be allowed to recoup the costs associated with maintaining them. Such programs provide very significant security benefits to consumers, and the deterrence of fraud is essential for maintenance of public trust in debit card systems. However, given the fluidity of the debit marketplace, a Technology-Specific Approach may result in edicts requiring implementation of systems that may or may not deter fraud. We believe the marketplace should be allowed to experiment with evolving technologies to identify those fraud-prevention systems that provide the greatest benefits for the costs incurred. Therefore, NETS supports a Non-Prescriptive Approach for purposes of implementing the fraud-adjustment provisions of the Durbin Amendment.

Furthermore, as noted above, we believe that fraud losses should be included either as part of an issuer's allowable incremental costs or as part of the fraud-prevention adjustment. Unlike bad checks, which generally impose the risk of fraud losses on merchants, risks of fraudulent debit transactions are borne by issuers. If these costs are not included in an issuer's allowable costs, they should be recoverable as part of the fraud adjustment.

*G. Three-Party Networks and Third-Party Intermediaries should not benefit unfairly from the Durbin Amendment.*

The Board has requested comment on the appropriate application of the interchange fee standards to electronic debit transactions carried over three-party systems, as well as whether third-party payment intermediaries, such as PayPal, should be covered by the Proposed Rule. As we have indicated, we believe the Durbin Amendment represents a dramatic government intervention in the debit card marketplace. We believe that three-party networks and alternative

payment platforms would benefit unfairly if they were excluded from the application of the Proposed Rule and that the final rule should be made to apply equally to payment devices that utilize three-party systems and third-party payment intermediaries' platforms.

*H. Net Compensation: The Board should address how the "net compensation" rule would apply to networks that are owned by or affiliated with processors.*

As the Board is aware, several major PIN-debit networks are owned by or affiliated with processors. While all networks are covered by the net compensation rule, processors and other network affiliates are not precluded from entering into arrangements with issuers that have relationships with both the network and the processor (or another network affiliate). Such arrangements could be used to pay net compensation to an issuer indirectly, through reductions in fees charged by processors, signing bonuses or similar arrangements. We are concerned networks that are affiliated with processors may be able to evade the net compensation rule and strongly encourage the Board to disqualify such networks from serving as an "unaffiliated network" for purposes of the routing restrictions since such issuer-processors may be able to utilize these arrangements to undercut competition to establish issuer relationships. Alternatively, we would urge the Board to include guidance either in the Official Board Commentary or the Proposed Rule itself that addresses the potential for such indirect compensatory arrangements.

*I. Net Compensation: The Board should clarify in the Staff commentary that the net compensation rules would not be violated if market forces cause shifts in issuer network fees to acquirer network fees.*

In the Preamble to the Proposed Rule, the Board acknowledged that reductions to issuer network fees 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. See Proposed Rule at 107. We concur with the Board's position and would encourage the Board to include a similar comment in the Official Board Commentary to the Proposed Rule.

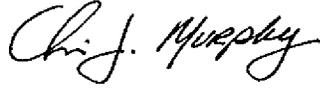
*J. Exemptions: Exempt issuers should be required to notify the network annually of their exempt status but within time frames established by the networks.*

We believe the certification process for exempt issuers is workable and would suggest the Board grant networks the flexibility to determine the appropriate timeframes for determining notice. Upon receipt of the notification, network systems can be programmed to identify exempt issuers based on a financial institution's BIN number. We believe that industry participants are best suited to address the many complex issues, such as shared BIN arrangements, that may necessarily make identification of certain exempt issuers a complex matter.

### III. Conclusion

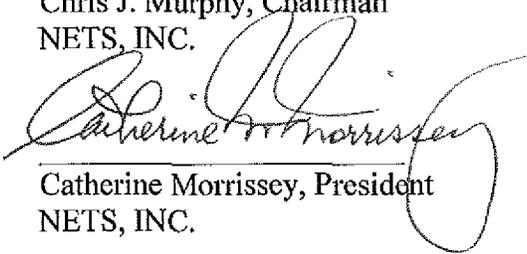
We respectfully urge the Board to consider our comments and suggestions. If you have any questions, or would like to discuss any of the matters outlined above in further detail, please do not hesitate to contact us at (402) 434-8234.

Sincerely,



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Chris J. Murphy, Chairman  
NETS, INC.



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Catherine Morrissey, President  
NETS, INC.