DISCOVER
FINANCIAL SERVICES

February 22, 2011

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

RE: Proposed Debit Rules, Docket No. R–1404; RIN 7100-AD63

Dear Ms. Johnson:

This letter is submitted to the Board of Governors of the Federal Reserve System (the "Board") on behalf of Discover Financial Services and PULSE Network, LLC (collectively, "we," "us," and "our"), in response to the Board's proposed rules relating to interchange transaction fees, network exclusivity restrictions and routing restrictions published in the Federal Register on December 28, 2010 (the "Proposed Regulations").[1] The Proposed Regulations were introduced to implement Section 1075 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Durbin Amendment").[2]

Discover Financial Services is a leading consumer lending company in the United States that offers credit cards and personal and student loans. Discover Financial Services also owns an electronic payments company that operates the Discover Network, a credit card, signature debit card and prepaid card payments network; the PULSE Network, a PIN debit, automated teller machine ("ATM") and electronic funds transfer network; and Diners Club International, a global payments network. The PULSE Network is one of the nation's leading PIN debit/ATM networks, and links cardholders of more than 4,400 financial institutions with point-of-sale terminals and ATMs located throughout the United States. PULSE also operates a global ATM network that provides cash access services to Discover and Diners Club cardholders at more than 750,000 ATMs in more than 80 countries around the world.

The principal policy objective of the Durbin Amendment is to promote competition among issuers and payment card networks in the debit card marketplace. The principal policy objective of the Electronic Fund Transfer Act (the "EFTA"), of which the Durbin Amendment is a part, is consumer protection. The Durbin Amendment contains both specific mandates and general guidelines for the Board to follow in implementing rules that achieve Congress's objectives. While the Proposed Regulations reflect the Board's thoughtfulness in accomplishing this challenging task, in certain

[1] Debit Card Interchange Fees and Routing, 75 Fed. Reg. 81,722 (December 28, 2010).
[2] Pub. L. 111-203, 2010 H.R. 4173, 111th Cong. (July 15, 2010).

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instances the Proposed Regulations exceed the boundaries of Congressional mandates, and in other instances the Proposed Regulations represent an arbitrary exercise of regulatory discretion that would likely lead to negative unintended consequences. In revising the Proposed Regulations prior to finalization, the Board should adhere to the plain meaning of the text where the Durbin Amendment provides specific mandates and that the Board exercise its interpretive discretion carefully and reasonably where the Durbin Amendment provides broader guidelines and parameters. Further, we encourage the Board, in revising the Proposed Regulations, to be mindful of the policy objectives of the Durbin Amendment and the EFTA and, in so doing, avoid outcomes that will diminish—rather than foster—competition in the debit card market or that will otherwise be harmful to consumers. Accordingly, we submit the following comments with respect to the Proposed Regulations.

## I. Interchange Transaction Fee Restrictions

The Board was directed by Congress to establish standards for assessing the appropriateness of interchange transaction fees within the parameters of the Durbin Amendment. Consistent with the views of many industry trade associations, we believe that the Board's implementation of the interchange transaction fee restrictions in the Proposed Regulations deviates from the requirements of the Durbin Amendment and is likely to have unintended and unnecessary adverse consequences without offsetting benefits. In addition, we submit our perspectives on the following: application of the interchange transaction fee restrictions on a per transaction basis; interpretation of the prohibition on circumvention or evasion of the interchange transaction fee restrictions; and the timing and scope of the adjustment for fraud-prevention costs.

### A. <u>The implementation of the interchange transaction fee restrictions in the Proposed Regulations is arbitrary and inconsistent with the plain meaning of the Durbin Amendment</u>.

The Durbin Amendment requires that interchange transaction fees "be reasonable and proportional to the cost incurred by the issuer with respect to the transaction"[3] (the "<u>Interchange Fee Restrictions</u>"). Congress directed the Board to implement this requirement through rulemaking and to follow two directives in doing so: (i) "consider the functional similarity between electronic debit transactions; and checking transactions that are required . . . to clear at par," and (ii) consider "the incremental cost incurred by an issuer for the role of the issuer in the authorization, clearance, or settlement of a particular electronic debit transaction" but not costs that are not specific to electronic debit transactions.[4] In our view, the Board deviated from Congress's express rulemaking mandates and unreasonably exercised its interpretive authority by: (i) establishing interchange transaction fee caps when it was only authorized to *establish standards for assessing* the appropriateness of interchange transaction fees; (ii) misapplying the "reasonable" and "proportional" determinations required by the Durbin Amendment, resulting in a determination that interchange transaction fees must be limited to no more

[3] EFTA § 920(a)(2).
[4] § 920(a)(4).

than the issuer's allowable costs; (iii) limiting the costs recoverable through interchange transaction fees to only incremental costs associated with authorization, clearance, and settlement; and (iv) interpreting "incremental costs" to mean "average variable costs," notwithstanding commonly-accepted economic definitions of the statutory term "incremental costs." The resulting limitation on interchange transaction fees to only narrowly-defined allowable costs, which excludes recovery of many costs associated with electronic debit transactions and debit card programs, as well as any return on investment, fails to adhere to the plain meaning of the text of the Durbin Amendment. It also reflects an arbitrary interpretation of the Durbin Amendment, violates the consumer-protection requirements of the EFTA, and constitutes an unconstitutional taking. Further, the severely limited interchange transaction fees under the Proposed Regulations will unnecessarily and artificially suppress the use of debit cards as a form of payment.

We endorse the comments regarding the Interchange Fee Restrictions contained in the joint trade comment letter filed collectively by The American Bankers Association, The Clearing House, The Financial Services Roundtable, The Independent Community Bankers of America, The Credit Union National Association, Midsize Bank Coalition of America, The National Association of Federal Credit Unions and The Consumer Bankers Association on February 22, 2011 (the "Joint Industry Letter"), and we request that the Board follow the recommendations in that letter regarding the implementation of the Interchange Fee Restrictions.

B. The Proposed Regulations implementing the Interchange Fee Restrictions should apply on a per transaction basis and should govern both the interchange transaction fee paid by the network to the issuer and the interchange transaction fee collected by the network from the merchant acquirer.

The Board noted in its discussion of the Proposed Regulations that both alternatives proposed for the implementation of the Interchange Fee Restrictions (Alternative 1 and Alternative 2) would be applied on a per-transaction basis (the "Transaction Level Approach").[5] However, the Board also suggested for consideration two other potential approaches: (i) an approach that allows an issuer to satisfy the Interchange Fee Restrictions by averaging the interchange transaction fees it receives for all electronic debit transactions over a set period of time (the "Issuer Level Approach"), and (ii) an approach that allows an issuer to satisfy the Interchange Fee Restrictions by participating in a payment card network that achieves a compliant average interchange transaction fee across multiple participating issuers (the "Network Level Approach").[6] The Board requested input regarding whether it should adopt either the Issuer Level Approach or the Network Level Approach instead of the Transaction Level Approach.[7]

We submit that the Transaction Level Approach is the correct approach. The language of the Durbin Amendment unambiguously requires the adoption of the

[5] 75 Fed. Reg. at 81,738.
[6] 75 Fed. Reg. at 81,738.
[7] 75 Fed. Reg. at 81,739.

Transaction Level Approach, and does not grant the Board latitude to deviate from this statutory mandate. The Issuer Level Approach and the Network Level Approach both contravene the statutory directive that the amount of any interchange transaction fee received or charged "shall be reasonable and proportional to the cost incurred by *the* issuer with respect to *the* transaction" (emphasis added).[8] In addition, there are significant policy considerations that support the Transaction Level Approach. The Issuer Level Approach and the Network Level Approach would each present a substantial administrative burden to issuers, payment card networks and regulators. By the Board's own admission, both the Issuer Level Approach and the Network Level Approach would require careful management by payment card networks and issuers of a complex process to ensure that, on an averaged basis, interchange transaction fees would meet the Interchange Fee Restrictions as implemented by the Proposed Regulations.[9] The equitable administration of such approaches would also require careful and challenging regulatory oversight.

We also submit that the Board should clarify that the Interchange Fee Restrictions apply to both the interchange transaction fees paid by payment card networks to issuers *and* the interchange transaction fees collected by payment card networks from merchant acquirers (a principal we refer to as "<u>Network Pass-Through Interchange Fees</u>"). In other words, for each transaction, the amount of the interchange transaction fee paid by the payment card network to the issuer should equal the amount of the interchange transaction fee collected by the network from the acquirer. This proposition is required by the statutory text: the Durbin Amendment regulates any "interchange transaction fee that an issuer may *receive or charge*" (emphasis added).[10] The "receive" portion of the statute clearly relates to the interchange transaction fees paid by payment card networks to issuers. The "charge" portion of the statute requires that the statutory restrictions also must apply to the interchange transaction fees that are charged to acquirers. Although interchange transaction fees charged to acquirers are established and collected by payment card networks, as a practical matter the networks perform this function on behalf of their issuers.

There are also significant policy considerations that support Network Pass-Through Interchange Fees. As a result of the Durbin Amendment's merchant routing controls, each merchant will likely choose to route electronic debit transactions through the payment card network that offers the lowest interchange transaction fees[11] for a given transaction. Understanding this, in the absence of Network Pass-Through Interchange Fees, payment card networks that have acceptance across a broader set of transaction types or merchants will have an incentive to:

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[8] § 920(a)(2).
[9] 75 Fed. Reg. at 81,738-39.
[10] EFTA § 920(a)(1).
[11] We recognize that merchants will likely make routing decisions based on the total cost of an electronic debit transaction to the merchant (including, for example, switch fees) and not just interchange transaction fees. However, since interchange transaction fees are likely to be the most significant component of total transaction cost to the merchant, we focus on the amount of interchange transaction fees in this discussion to more simply and clearly illustrate the point.

(i) set interchange transaction fees to acquirers at *artificially low levels* (below interchange transaction fees paid to issuers) for transaction types or merchants in industry sectors *where many merchants have chosen to adopt multiple authorization methods* (in an attempt to control the market for those transaction types or merchants); and

(ii) set interchange transaction fees to acquirers at *artificially high levels* (above interchange transaction fees paid to issuers) for transaction types or merchants in industry sectors *where fewer merchants have chosen to adopt multiple authorization methods* (to offset losses from the artificially low interchange transaction fees).[12]

In the short term, the effects of this bifurcated pricing scheme are clear—it will disproportionately benefit those merchants described in paragraph (i) above and will disproportionately harm those merchants described in paragraph (ii) above. However, over time, the artificially low interchange transaction fees required to compete for merchant routing in the industry sectors described in paragraph (i) above may drive out of the market those payment card networks that are unable to sustain artificially low interchange transaction fees. Allowing payment card networks to be forced out of the market by such behavior would result in reduced network competition for all transaction types and merchants. Such a result would contravene the Durbin Amendment's objective to promote competition among payment card networks.

In keeping with a plain reading of the Durbin Amendment and to promote rather than inhibit competition, the Board should maintain the application of the Interchange Fee Restrictions on a per-transaction basis and should clarify that the Interchange Fee Restrictions apply to the interchange transaction fees, both as paid by payment card networks to issuers and as collected from acquirers.

C. <u>The prohibition on circumvention or evasion of the Interchange Fee Restrictions should not prohibit payments from payment card networks to issuers that are not designed to compensate issuers for electronic debit transactions</u>.

The Durbin Amendment requires the Board to prescribe rules that: (i) prohibit the use of payment card network fees "to directly or indirectly compensate an issuer with respect to an electronic debit transaction" or to circumvent or evade the Interchange Fee Restrictions,[13] and (ii) prohibit other forms of circumvention or evasion of the Interchange Fee Restrictions.[14] To implement this directive, the Board has proposed an overarching rule under which any net compensation from a payment card network to an

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[12] An argument can be made that implementation of the Durbin Amendment's network exclusivity and routing restrictions, particularly under Alternative B, would foster sufficient competition between networks to limit the ability of a network to engage in this type of bifurcated pricing scheme. However, the Board should not rely on the network exclusivity and routing restrictions to accomplish what the plain meaning of the statute already requires: Network Pass-Through Interchange Fees.

[13] § 920(a)(8)(B)(i).

[14] § 920(a)(1).

issuer "with respect to electronic debit transactions" (other than allowable interchange transaction fees) is deemed to constitute circumvention or evasion (the "Net Compensation Restriction").[15] As written, the Net Compensation Restriction appears to fall within the rulemaking authority granted by Congress. However, the Board's proposed application of the Net Compensation Restriction unjustifiably exceeds the statutory grant of authority and the text of the proposed rule itself by prohibiting any net compensation from a payment card network to an issuer "*for debit card related activities*"[16] (as opposed to only prohibiting any net compensation "*with respect to electronic debit transactions*"[17]) (emphasis added). As a result, the anti-circumvention portions of the Proposed Regulations would prohibit all net compensation from payment card networks to issuers, including legitimate and appropriate payments that are not tied to electronic debit transactions but that promote payment card network competition and payments system efficiency.

Payments from a payment card network to an issuer relating to the network's role as allocator of risk among network participants should be exempt from the Net Compensation Restrictions, so long as such payments are not tied to electronic debit transactions. Currently, in the event of a merchant or acquirer data security breach, payment card networks may assess fees to a negligent merchant and/or acquirer and pay amounts collected to affected issuers to cover some of the costs incurred by them in responding to the breach (such as card re-issuance and related services). This re-allocation of costs in the event of a data security breach provides merchants and acquirers an incentive to minimize breach risks and mitigates some of the uncontrollable and unplanned financial impact of breaches to issuers. Payment card networks' use of fees and payments to allocate costs among network participants in this way enhances the efficiency and fairness of the payments system. Despite the necessary and appropriate function of these payments that are wholly unrelated to interchange transaction fees, they could nevertheless be subject to the Board's expansive application of the Net Compensation Restriction to all payments "for debit card related activities."

Signing bonuses and other financial incentives used by payment card networks to attract and retain issuers and advance strategic network goals should also be exempt from the Net Compensation Restriction, so long as these payments are not tied to electronic debit transactions. For example, a payment card network may offer an issuer a signing bonus as an incentive to join the network or to merely reimburse the issuer for the costs of joining the network (such as systems development and integration). In addition, a payment card network may choose to offer incentive payments to issuers to encourage them to upgrade their systems to increase uptime or decrease network connectivity issues. As the Board correctly acknowledged in the Proposed Regulations, such payments "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" and subjecting such payments to the Net Compensation Restriction "could constrain a network's ability to grow the network and achieve greater

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[15] 75 Fed. Reg. at 81,756.
[16] 75 Fed. Reg. at 81,762.
[17] 75 Fed. Reg. at 81,756.

network efficiencies."[18] In contrast, the concern the Board expressed in the Proposed Regulations that signing bonuses would vitiate the purpose of the Net Compensation Restriction are unfounded. Enforcement of the Net Compensation Restriction as the text of the rule is currently drafted (without the unauthorized expansion of the restriction to cover all payments *related to debit card activities*) would still ensure that signing bonuses and other incentive payments cannot be structured to compensate issuers for electronic debit transactions in contravention of the Interchange Fee Restrictions.

Further, applying the Net Compensation Restriction to legitimate signing bonuses and other financial incentives would unjustifiably favor certain payment card networks over others and could lead to unintended adverse outcomes. For example, if signing bonuses were subject to the Net Compensation Restriction, payment card network operators that, directly or through affiliates, offer products and services unrelated to their operation of the network could offer issuer customers discounts on those other products and services, thereby effectively offering an incentive for an issuer's use of the network without violating the Net Compensation Restriction. In contrast, an operator of a payment card network that did not have unrelated products or services to offer would be precluded from using a signing bonus or other legitimate payment to compete effectively. The natural outcome of the competitive disequilibrium fostered by an overbroad application of the Net Compensation Restriction would be a defection of issuers from payment card networks that could not offer incentives to those that could.

For these reasons, we submit that the Board should not expand the application of the Net Compensation Restriction beyond payments from payment card networks to issuers made in connection with, and as compensation for, electronic debit transactions. In its current form (as expanded by commentary to apply to any payments for debit card related activities), the anti-circumvention provision of the Proposed Regulations is not authorized by Congress and will hinder efficiency and competition, potentially causing substantial and unnecessary harm to the debit card marketplace.

D. The Interchange Fee Restrictions and the allowance for a fraud-prevention adjustment should be made effective at the same time and the adjustment should be made broadly available.

The Durbin Amendment permits the Board to allow for an adjustment to regulated interchange transaction fees if: "(i) 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 (ii) the issuer complies with fraud-related standards established by the Board."[19]

The Interchange Fee Restrictions are scheduled to take effect on July 21, 2011.[20] However, the Proposed Regulations did not include specific regulatory proposals to implement the fraud-prevention adjustment and did not indicate a date by which such an

[18] 75 Fed. Reg. at 81,748.
[19] § 920(a)(5)(A).
[20] § 920(a)(9).

adjustment would take effect.[21] We submit that the Board should ensure that the Interchange Fee Restrictions and the fraud-prevention adjustment become effective at the same time. Permitting the Interchange Fee Restrictions to take effect in the absence of simultaneous effectiveness of the fraud-prevention adjustment would compound the impact on issuers of substantially reduced interchange transaction fees contemplated by the Proposed Regulations. It would also fail to provide any financial accommodation or incentive to issuers to invest in new, or even maintain current, fraud-prevention mechanisms. The result could be an overall decline in issuers' fraud-prevention efforts, which would be harmful to consumers and to the payments system as a whole.

The Board offered and sought comment on two alternative fraud-prevention frameworks in the Proposed Regulations—a technology-specific approach and a non-prescriptive approach.[22] We encourage adoption of the non-prescriptive approach, which would allow individual issuers the flexibility to meet the Board's fraud-prevention standards in a manner that is most efficient and effective for each issuer. Fraud may be prevented through a variety of mechanisms, and effective fraud-prevention technologies are constantly evolving. The Board's adoption of technology-specific standards would confine issuers to predetermined fraud-prevention measures that might become outdated or ineffective over time and would unnecessarily limit issuer fraud-prevention techniques and innovation. Instead, the Board's fraud-prevention adjustment should allow issuers to embrace innovative fraud-prevention technologies based on card and transaction characteristics. Issuers should be encouraged to seek out—and even develop—the best available options to prevent fraud. The adopted approach should be broad enough to account for and accommodate the fraud-prevention characteristics that are inherent to certain authorization methods and certain form factors. For example, if a transaction initiated using an innovative debit card form factor is inherently less prone to fraud than the typical signature debit transaction, the issuer of that form factor should receive a fraud-prevention adjustment for that transaction as compensation for the additional costs incurred with respect to the development and deployment of the fraud-reducing form factor. In light of the constant evolution of fraud-prevention tools, the market, and not the Board, is better positioned to determine the most effective technologies to fight fraud.

The Board also specifically sought comment on whether it should "consider adopting an adjustment for fraud-prevention costs for only PIN-based debit card transactions, but not signature-based debit transactions . . . given the lower incidence of fraud and lower chargeback rate for PIN-debit transactions."[23] We believe the adjustment for fraud-prevention costs should be available for all transaction authorization methods. In developing the Proposed Regulations, the Board conducted surveys of debit card issuers, payment card networks and merchant acquirers to obtain information about the nature and types of fraud that occur in connection with electronic debit transactions.[24]

[21] 75 Fed. Reg. at 81,740. While the Durbin Amendment did not set an effective date for implementing the fraud-prevention adjustment rule, the Board is required to issue final rules to establish standards for making fraud-prevention adjustments by April 21, 2011, the same date on which final rules for the Interchange Fee Restrictions are required. § 920(a)(5)(B)(i).

[22] 75 Fed. Reg. at 81,740 and 81,742-43.

[23] 75 Fed. Reg. at 81,742.

[24] 75 Fed. Reg. at 81,740.

Although the surveys revealed that current fraud losses associated with signature debit transactions are greater than those associated with PIN debit transactions—roughly \$1.15 billion compared to \$200 million, respectively, in 2009[25]—both types of electronic debit transaction suffer from fraud, and the levels inherent to each authorization method may change over time. Limiting the fraud-prevention adjustment by authorization method could lead to reduced issuer investment in fraud-prevention efforts that focus on the types of debit transactions for which a fraud-prevention adjustment is not permitted, yielding an undesirable result and payments system inefficiencies.

## II. Network Exclusivity and Routing Restrictions

The Board was required under the Durbin Amendment to prescribe regulations prohibiting a payment card network or issuer from restricting the networks on which an electronic debit transaction may be processed to a single network or affiliated group of networks (the "Network Exclusivity Restrictions").[26] In addition, Congress directed the Board to prescribe complementary regulations prohibiting a payment card network or issuer from inhibiting the ability of any person who accepts debit cards for payments to route an electronic debit transaction over any network that is enabled to process the transaction (the "Routing Restrictions;" collectively with the Network Exclusivity Restrictions, the "Network Exclusivity and Routing Restrictions").[27]

The Proposed Regulations offer two alternatives for implementing the Network Exclusivity Restrictions: (i) Alternative A, which prohibits payment card networks and issuers from limiting the number of networks available for processing an electronic debit transaction to fewer than two unaffiliated networks, *regardless of the means by which a transaction may be authorized*; and (ii) Alternative B, which prohibits payment card networks and issuers from limiting the number of networks available for processing an electronic debit transaction to fewer than two unaffiliated networks *for each method by which a transaction may be authorized.*[28] Alternative A satisfies the statutory requirements of the Durbin Amendment while minimizing unintended and unnecessary adverse consequences. In contrast, Alternative B is neither required nor authorized by the Durbin Amendment, and its adoption will unnecessarily burden issuers and networks, harm consumers, and reduce competition in the debit card marketplace without a corresponding benefit. Additionally, regardless of whether Alternative A, Alternative B or another alternative is adopted, the Network Exclusivity and Routing Restrictions should not be applied to alternative payment form factors or three-party systems. The application of the Network Exclusivity and Routing Restrictions to alternative payment form factors is not required by the Durbin Amendment and would stifle innovation and harm consumer choice. The application of those restrictions to three-party systems (where the payment card network and issuer are the same entity) is impractical and inequitable.

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[25] 75 Fed. Reg. at 81,741.
[26] § 920(b)(1)(A).
[27] § 920(b)(1)(B).
[28] 75 Fed. Reg. at 81,749.

A. Alternative A adheres closely to the statutory text and fully implements the objectives of the Durbin Amendment.

Alternative A is consistent with and achieves the intended objectives of the Durbin Amendment by prohibiting payment card networks and issuers from limiting the number of networks available for processing an electronic debit transaction to fewer than two unaffiliated networks. Under the plain meaning of the text of the Durbin Amendment, the Board is directed (and indeed only authorized) to require two unaffiliated payment card networks per debit card. Provided a debit card supports the routing of transactions on at least two unaffiliated payment card networks, regardless of authorization method, the letter and intent of the Durbin Amendment are satisfied. Alternative A requires two unaffiliated payment card networks per debit card. We therefore submit that the Board should adopt Alternative A to implement the Network Exclusivity Restrictions.

The Board requested comment on a potential effective date of October 1, 2011, for the Network Exclusivity and Routing Restrictions if the Board selects Alternative A.[29] We believe that the proposed effective date is achievable from a payment card network perspective, but recognize that some issuers may require more time to identify additional payment card networks and complete contract negotiations to comply with Alternative A requirements.[30]

B. Alternative B is not authorized by the Durbin Amendment, is unnecessary and will result in unintended adverse consequences.

Alternative B, which prohibits limiting the number of payment card networks available for processing an electronic debit transaction to fewer than two unaffiliated networks for each method by which a transaction may be authorized, exceeds the requirements of the Durbin Amendment. The Durbin Amendment expressly defines electronic debit transactions as inclusive of *all* electronic debit transactions regardless of the authorization method used to initiate the transaction. Specifically, the Durbin Amendment defines an "electronic debit transaction" as a "transaction in which a person uses a debit card,"[31] and "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 . . . *whether authorization is based on signature, PIN, or other means*"[32] (emphasis added). Congress did not distinguish anywhere in the Durbin Amendment, and did not authorize the Board to differentiate, between electronic debit transactions based on authorization method. The Board even acknowledged this fact by stating that "the statute does not

[29] 75 Fed. Reg. at 81,753.
[30] We note that the transition to compliance with the Network Exclusivity and Routing Restrictions will be much easier—and the proposed effective date more achievable—if the Board clarifies that network payments that are not tied to the number or volume of electronic debit transactions processed on the network are not subject to the Net Compensation Restriction (as discussed in Section I.C. above).
[31] § 920(c)(5).
[32] § 920(c)(2).

expressly require issuers to offer multiple unaffiliated signature and multiple unaffiliated PIN debit card network choices on each card."[33]

Despite the fact that the Durbin Amendment does not distinguish among electronic debit transactions by method of authorization, the Board nevertheless proposed Alternative B due to reservations over whether Alternative A would provide merchants with adequate routing choice. Specifically, the Board expressed concern that, in some circumstances, a merchant's routing choices would be limited notwithstanding the presence of two unaffiliated payment card networks on each debit card because many merchants do not support PIN debit as an authorization method.[34] However, this concern is unwarranted. PIN debit is currently available for virtually every transaction type and the cost to a merchant of deploying the technology to support PIN debit is relatively insignificant. With few exceptions, where PIN debit is not available it is because of merchant choice alone. Implementing Alternative B to ensure that merchants that have voluntarily limited their routing options by declining to support PIN debit is nothing more than an unauthorized and unjustified regulatory shift of the burden and costs of these merchants' self-inflicted routing limitations to payment card networks and issuers. Further, under the very limited circumstances where PIN debit is not currently practical or feasible as an authorization method, technological advances are rapidly evolving to make PIN debit solutions and other authorization methods increasingly available, provided these innovations are not hindered by the adoption of Alternative B (as described in Section II.C. below). The Canadian and European debit card markets (where signature debit is largely non-existent) demonstrate that, as the demand for PIN debit increases, so will the supply of innovative and cost-effective acceptance solutions. For example, many secure solutions for PIN debit acceptance for Internet purchases now exist, even though use of PIN debit for these transactions was considered impractical just a few years ago. Finally, it would be inappropriate to base the network exclusivity rules on the primary method used to authenticate transactions on a particular network, because as the debit card marketplace continues to evolve, this distinction is becoming increasingly artificial. Even today, many "signature" debit transactions do not require a signature, and many "PIN" debit transactions are completed without entering a PIN. For these reasons, there are no reasonable statutory or policy grounds supporting an overly broad requirement for the enablement of at least two unaffiliated payment card networks per method of authorization.

Adoption of Alternative B also would be unreasonably burdensome as it would require issuers and payment card networks to overcome substantial technical barriers. For example, as the Board discussed in the Proposed Regulations, enabling multiple signature debit payment card networks on a card would require a significant number of changes within the industry, including "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."[35]

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[33] 75 Fed. Reg. at 81,749.
[34] 75 Fed. Reg. at 81,749-50.
[35] 75 Fed. Reg. at 81,749.

Further, compliance with Alternative B could be particularly burdensome for smaller issuers, an outcome also acknowledged by the Board. The Board wrote that "small debit card issuers could be disproportionately affected by a requirement to have multiple networks for each method of debit card authorization" and that "Alternative A would minimize the overall compliance costs for these issuers."[36] Incidentally, these challenges could also result in a much longer and less predictable transition to compliance with the Network Exclusivity and Routing Restrictions under Alternative B.

In addition to being unauthorized by the Durbin Amendment and unnecessarily burdensome to issuers and payment card networks, Alternative B would likely have a negative impact on consumers. The Board acknowledged in issuing the Proposed Regulations that adopting Alternative B "could have adverse effects" on consumers.[37] Specifically, requiring multiple payment card networks per authorization method, in combination with merchant routing choice as mandated by the Routing Restrictions, would prevent consumers from having knowledge of or control over the payment card network over which their electronic debit transactions would be routed.[38] This lack of knowledge or control could "reduce the likelihood that the cardholder would be able to obtain benefits that are specific to a particular card network"—benefits that were likely to have been important to the consumer's decision in selecting the transaction authorization method, the type of card to use for a particular purchase, or perhaps even the type of card to apply for from the issuer in the first place. For example, certain payment card networks offer cardholder benefits in connection with the processing of electronic debit transactions over their network. Such benefits include zero cardholder liability for fraud, enhanced chargeback rights, extended warranty protection on purchases, insurance benefits, fraudulent activity detection and alerts and rewards.

Further, requiring at least two unaffiliated networks per method of authorization would likely inhibit the development of new debit authorization methods and technologies.[39] As discussed in greater detail below, we believe that the Network Exclusivity and Routing Restrictions should not apply to alternative form factors. More broadly, we note here that Alternative B would be far more likely than Alternative A to stifle innovation generally. Under Alternative B, innovative authorization methods, such as the successors to mobile devices and Near Field Communication (NFC) technology, may not be developed or implemented, as these authorization methods may be incapable of being processed on multiple unaffiliated networks, at least for some period of time after introduction. Even if such technologies were capable of being processed on other networks, the stakeholders of such innovations may be reluctant to develop and deploy new technologies if they are required—in order to comply with the Proposed Regulations—to share their original, proprietary inventions with competitors. Ultimately, Alternative B will stifle the growth of these innovations that have benefited the debit card marketplace as a whole and its participants.

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[36] 75 Fed. Reg. at 81,749.
[37] 75 Fed. Reg. at 81,748.
[38] 75 Fed. Reg. at 81,748-49.
[39] 75 Fed. Reg. 81,749, 81,751.

Finally, Alternative B, together with the Proposed Regulations implementing the Interchange Fee Restrictions, may have the unintended effect of reducing rather than enhancing competition among payment card networks. The financial viability of issuers, already negatively impacted by the very limited interchange transaction fees permitted under the Proposed Regulations and by other recent statutory and regulatory changes, will be further harmed by the substantial costs required for issuers to comply with Alternative B. As a result, Alternative B may cause at least some issuers that cannot continue to operate debit programs on a fiscally sound basis to restrict access to their debit programs, decreasing market competition and consumer choice in debit card services. In addition, those issuers that continue to operate debit programs will likely need to aggressively pursue debit card program cost reductions to limit program losses. One avenue through which issuers may seek to reduce costs is the minimization of payment card network connections that they must establish and maintain. The large majority of debit cards in the market today have both signature debit and PIN debit capabilities. Participation in two payment card networks that each supports both signature debit and PIN debit authorization capabilities would represent the minimum possible number of payment card network connections that issuers of dual-authorization method cards would be required to maintain to meet the requirements of Alternative B. Thus, Alternative B would encourage consolidation of issuer participation on the largest payment card networks that, together with their affiliates, support multiple routing options (e.g., networks that support both signature debit and PIN debit authorization technologies). This phenomenon would reduce, rather than enhance, network competition and merchant routing choice and could force certain payment card networks that do not support both signature debit and PIN debit technologies (which is characteristic of the majority of payment card networks) out of the market. The market consolidating impact of Alternative B ultimately would result in less competition and less choice for consumers and merchants, which is antithetical to the overarching objectives of the Durbin Amendment and contradicts the EFTA's purpose of protecting consumer rights.[40]

Under Section 904 of the EFTA, the Board must "prepare an analysis of economic impact which considers the costs and benefits to financial institutions, consumers, and other users of electronic fund transfers . . . and the effects upon competition in the provision of electronic banking services among large and small financial institutions and the availability of such services to different classes of consumers, particularly low income consumers"[41] for any regulation proposed under the EFTA, and where possible "demonstrate that the consumer protections of the proposed regulations outweigh the compliance costs imposed upon consumers and financial institutions."[42] Nowhere in the Proposed Rule or its accompanying discussion did the Board specify that it conducted this required analysis. Had it done so, the Board likely would have concluded that Alternative B would have a negative impact on consumers with little, if any, offsetting consumer benefit. Accordingly, we reiterate that the Board should adopt Alternative A in the final rules and submit that the adoption of Alternative B would result in unintended

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[40] 15 U.S.C. § 1693(b).
[41] 15 U.S.C. § 1693b(a)(2).
[42] 15 U.S.C. § 1693b(a)(3).

and unnecessary adverse consequences to issuers, payment card networks, consumers and competition in the debit card marketplace.

C. To avoid stifling consumer choice and innovation, the Board should clarify that the Network Exclusivity and Routing Restrictions do not apply to alternative payment form factors.

The Board requested comment on the impact the proposed Network Exclusivity and Routing Restrictions would have on innovative payment form factors.[43] Significant policy considerations, including protection of consumer choice and potential harm to competition and innovation, support that Network Exclusivity and Routing Restrictions should not apply to alternative payment form factors. For these reasons, we submit that the Board should continue in the present rulemaking its historical reluctance to issue regulations that threaten innovation.

The application of the Network Exclusivity and Routing Restrictions to certain alternative payment form factors would undermine a consumer's choice of payment card network, a choice that the Durbin Amendment was not intended to restrict. For instance, some consumers may elect to use an alternative payment form factor as an add-on to a compliant debit card. In such cases, the consumer voluntarily requests or enables the alternative payment form factor provided as an accompaniment to the traditional debit card and subsequently chooses to use the alternative payment form factor rather than the traditional debit card for payment for goods or services. Because the alternative payment form factor is enabled for only one network, while the consumer would be free to use the associated traditional debit card for any payments, the consumer also may elect to use the alternative form factor to make payment and, in so doing, affect network routing. This cardholder election to enable and use an alternative payment form factor to initiate an electronic debit transaction is substantively the same as a cardholder election to initiate an electronic debit transaction by signature or PIN debit at the point-of-sale. The Durbin Amendment was not intended to limit the ability of a consumer to express a preference for one authorization method over another at the point-of-sale or to limit the consumer's influence over transaction routing. However, the application of the Network Exclusivity and Routing Restrictions to certain alternative payment form factors, even where associated with a compliant debit card, would have the same substantive effect by undermining the choice a consumer makes when he or she activates a payment form factor for use on a specific payment card network and elects to use that payment form factor to initiate an electronic debit transaction.

In addition, innovation will be stifled if alternative payment form factors are required to participate in multiple, unaffiliated payment card networks. As the Board recognized in the Proposed Regulations, many innovative payment form factors that are not standard debit cards, such as key fobs and mobile payment devices, can only be processed on signature debit payment card networks or on certain networks tailored to that unique device.[44] Generally speaking, support of new payment form factors requires

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[43] 75 Fed. Reg. at 81,751.
[44] 75 Fed. Reg. at 81,751.

significant investments by payment card networks in a number of areas, including investments related to technology development and deployment, and changes to operating rules and technical specifications. If these investments will not result in adequate returns to the investing payment card network, due to the obligation to share the fruits of investment with other payment card networks or perhaps even to pay other networks to support the resulting technology, networks will be much less willing to make such investments in the future. For example, requiring an innovative payment form factor to be accepted on two unaffiliated payment card networks when multiple network options may not be technologically available would hinder the continued development and use of mobile payments technology, which is generally supported only on signature debit networks and which is currently advancing due in large part to significant, proprietary developments and investment by various payment card networks. Indeed, the nature of the Board's request for comment indicates that it is aware that the proposed Network Exclusivity and Routing Restrictions could harm innovation.[45] If each payment card network is required to both voluntarily share its innovative inventions with competing payment card networks and convince those competing networks to enhance their systems to support the innovation, the additional substantial risks to achieving a return on investment will surely have a chilling effect on innovation.

The Proposed Regulations implementing the Network Exclusivity and Routing Restrictions also may provide payment card networks the ability to block the adoption of new payment form factors by electing not to support the form factors developed or implemented by competing networks. Even when it is technologically feasible, a competing, unaffiliated payment card network may not be willing to support an innovative payment form factor if a competitor benefits disproportionately from the use of the form factor. This may be particularly true if a competing payment card network earns revenue from the adoption of a particular innovation. If the proposed Network Exclusivity Restrictions are applied to innovative payment form factors and no other payment card networks are willing to support the technology, the innovation will wither regardless of its desirability to merchants and consumers because it cannot be deployed in a manner that complies with the Network Exclusivity Restrictions. This would have an unintended, negative impact on payments system innovation and competition that is inconsistent with the foundational objectives of the Durbin Amendment and the EFTA.

The Board has historically been reticent to adopt regulations that may harm innovation. For example, the Board recognized the prevalence of emerging payment form factors in the official commentary to the regulations that implemented the Credit Card Accountability and Responsibility and Disclosure Act of 2009 (the "Credit CARD Act").[46] There, the Board provided that a gift card issuer's issuance of a small-form factor gift card that lacks the required on-card disclosures would not violate the Credit CARD Act so long as the cardholder is provided with a legally compliant gift card that accompanies the otherwise non-compliant card.[47] Likewise, in 2006, when the Board proposed rules to extend the scope of Regulation E protections to payroll card accounts,

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[45] 75 Fed. Reg. at 81,751.
[46] Pub. Law No. 111-24.
[47] Official Commentary to 12 C.F.R. 205.20(c)(4).

the Board expressly declined to also regulate general-use prepaid cards. The Board justified this measured approach, in part, on the grounds that regulations could stifle innovation. The Board also noted that "coverage of [general-use prepaid cards] could impede the development of other card products generally."[48] The Board should continue its historical practice of avoiding the application of regulations, such as the Network Exclusivity and Routing Restrictions, in a manner that is likely to stifle innovation and harm competition and consumers.

D. <u>The Network Exclusivity and Routing Restrictions should not apply to three-party systems</u>.

As part of its discussion of the scope of the Proposed Regulations, the Board specifically requested comment on the application of the Network Exclusivity and Routing Restrictions to three-party systems.[49] As an initial matter, we request clarification on the Board's characterization of three-party systems. We also submit that the Board should not apply the Network Exclusivity and Routing Restrictions to three-party systems because doing so would force network/issuers in three-party systems to enable competing payment card networks on their debit cards and would introduce systematic inefficiencies.

The Board has characterized a three-party system as one in which the payment card network is both the issuer and the acquirer.[50] However, this ignores the fact that the owners of certain major three-party systems provide network operation and issuing functions, but not necessarily an acquiring function. In addition, given that the Proposed Regulations are primarily focused on regulating the network-issuer relationship, it is logical and appropriate to define the operative qualifying characteristic of a three-party system as affiliation between the payment card network and the issuer, without regard to whether the merchant acquiring function is also performed by an affiliated entity. Accordingly, the Board should clarify that its use of the term "three-party system" in the Proposed Regulations refers to any system in which network operation and issuing functions are performed by the same entity.

Applying the Network Exclusivity and Routing Restrictions to three-party systems would result in an inequitable and impractical outcome for the network/issuer and other network participants. For a three-party system to comply with the Network Exclusivity and Routing Restrictions, the network/issuer of the three-party system would be legally obligated to induce another, competing payment card network operator to support cards issued by the network/issuer for participation on the competing network. Payment card networks are unlikely to willingly support (and even less likely to provide fair and equal treatment) to debit cards issued by an issuer that also operates a competing network, particularly when *not* doing so would potentially eliminate the three-party system's competing debit cards from the marketplace. Further, as the Board acknowledged in its discussion of the Proposed Regulations, there are significant

48 Electronic Fund Transfers, 71 Fed. Reg. 1473, 1475 (January 10, 2006).
49 75 Fed. Reg. at 81,727.
50 75 Fed. Reg. at 81,723.

practical challenges associated with the administration of the Proposed Regulations in the three-party system context. The Board accurately noted 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."[51] If the Network Exclusivity and Routing Restrictions were applied to three-party systems, despite the fact that a particular debit card is issued by the network/issuer, such card must be open for processing on unaffiliated payment card networks, which could lead to the inefficient and circuitous routing of electronic debit transactions (e.g., initially on the unaffiliated network and then back to the network/issuer).

## III. General

In numerous places throughout the Proposed Regulations and accompanying discussion and commentary, the Board requested comment on the applicability of the Proposed Regulations in certain circumstances and on the appropriateness of certain timeframes, deadlines and certification and reporting procedures.

### A. The Proposed Regulations should not apply to selective authorization cards.

The Board specifically requested comment on whether a prepaid card that is accepted at a limited number of unaffiliated participating merchants and does not carry a network brand (a "Selective Authorization Card") should be considered a "general-use prepaid card"[52] that is subject to regulation. We submit that Selective Authorization Cards should not be subject to the Proposed Regulations. As the Board has suggested, there is virtually no functional difference between Selective Authorization Cards and closed-loop, retail gift cards, which fall outside the scope of the Proposed Regulations.[53] Selective Authorization Cards simply serve as a shared closed-loop, retail gift card program for a group of merchants that have each deemed it efficient and mutually beneficial to operate a joint, rather than individual, closed-loop, retail gift card program. Further, as the Board acknowledged, subjecting Selective Authorization Cards to the Proposed Regulations will be unnecessarily burdensome and costly for merchants with no perceivable benefit to any party. The very merchants that structure and elect to use the Selective Authorization Card program would be the parties protected by the Proposed Regulations and would also be the parties that bear the costs of compliance with the Proposed Regulations.[54]

[51] 75 Fed. Reg. at 81,728.
[52] 75 Fed. Reg. at 81,730.
[53] 75 Fed. Reg. at 81,730.
[54] 75 Fed. Reg. at 81,730.

B. The Proposed Regulations should provide adequate timeframes and directions for reporting and certification.

In the Proposed Regulations, the Board requested comment on timeframes, deadlines, and certification and reporting procedures.

Proposed 12 C.F.R. § 235.3(d) requires an issuer to report to each payment card network through which it processes electronic debit transactions the maximum allowable interchange transaction fees the issuer may charge or receive.[55] The Board has proposed that an issuer make these reports by March 31 of each year and requested comment on whether: (i) such a deadline is necessary, and (ii) the proposed date is appropriate.[56] We believe that this deadline is necessary and that it should be at least ninety days prior to the date by which the Interchange Fee Restrictions become effective (July 21, 2011) to ensure that payment card networks have adequate time to process the information they receive. Accordingly, we support the March 31 proposal.

Section 920(a)(3)(B) of the EFTA permits the Board to collect information from issuers and payment card networks that it deems necessary for it to carry out the requirements related to establishing the Interchange Fee Restrictions. Pursuant to this authority, proposed 12 C.F.R. § 235.8 requires payment card networks and issuers to submit reports to the Board by March 31 of each year. We believe that this reporting deadline is appropriate, and should be no earlier than this date in order to allow issuers and payment card networks sufficient time to provide accurate and complete data to the Board.

The Board also requested comment on whether it should establish a certification process to identify issuers that qualify for a statutorily prescribed exemption from the Interchange Fee Restrictions, including the small issuer exemption.[57] We believe that the Board should promulgate such a certification process, including setting timeframes by which an issuer must report to the payment card network. We believe this will help to ensure that the exemptions are applied in a fair and consistent manner. We recommend that timeframes for reporting an exemption be uniform, to the extent possible, so as to ease the administrative burden associated with a certification process. The requirement that issuers notify payment card networks of their status should extend only to those issuers that are non-exempt, which would be consistent with the rules for reporting contained in proposed 12 C.F.R. § 235.8 that require only non-exempt issuers to make reports to the Board. Correspondingly, exempt issuers should not be required to notify payment card networks of their exempt status.

[55] 75 Fed. Reg. at 81,739.
[56] 75 Fed. Reg. at 81,740.
[57] 75 Fed. Reg. at 81,743-44.

## IV. Conclusion

Congress provided both specific mandates and general guidelines for the Board to follow in developing rules to implement the Durbin Amendment. Where the text of the Durbin Amendment is clear, the Board must adhere closely to the plain meaning of the statute in its rulemaking. Where the statue is less specific, the Board must exercise its interpretive discretion reasonably and in a manner that is equitable and that promotes, rather than inhibits, competition. We urge the Board to reconsider the Proposed Regulations in light of these principles.

Specifically, with respect to the Interchange Fee Restrictions, the Board should adopt final rules that, in keeping with the letter and intent of the Durbin Amendment:

- implement an approach to assessing interchange transaction fees that is consistent with the recommendations espoused in the Joint Industry Letter;
- expressly specify that the interchange fees must be applied according to the Transaction Level Approach, including Network Pass-Through Interchange Fees;
- limit the scope of the Net Compensation Restriction to only those payment card network payments that are tied to electronic debit transactions processed on the network; and
- promulgate a broadly available fraud-prevention adjustment that is effective concurrent with the effectiveness of the interchange transaction fee restrictions.

Likewise, with respect to the Network Exclusivity and Routing Restrictions, the Board should adopt final rules that:

- adopt Alternative A, which is consistent with the plainest reading of the Durbin Amendment and accomplishes the objectives of the Durbin Amendment without the unnecessary and costly burdens that would accompany Alterative B;
- exempt alternative payment form factors to allow for consumer choice and to avoid the stifling of innovation; and
- exempt three-party systems to avoid an inequitable and inefficient outcome.

The final rules should allow sufficient time for parties to comply with their requirements. Where the Board has offered Proposed Regulations that are consistent with the statutory authority of the Durbin Amendment and are unlikely to cause adverse impacts, we encourage the Board to promulgate final rules in due course. Where the Board has offered Proposed Regulations that exceed the statutory authority of the Durbin Amendment or that have the potential to cause unnecessary adverse impacts, such as those relating to interchange transaction fees, we strongly urge the Board to develop rules that more appropriately apply the statute. If necessary, the Board should delay issuing further rules until it has had sufficient time to ensure that such rules faithfully and reasonably apply the statute.

Thank you for your consideration of our comments. If you have any questions or wish to further discuss our comments, please do not hesitate to contact us.

Sincerely,

Kelly McNamara Corley
Executive Vice President, General Counsel and Secretary
Discover Financial Services